



**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Basic Financial Statements and Required Supplementary Information

June 30, 2017

(With Independent Auditors' Report Thereon)

EMPLOYEES’ RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
(A Component Unit of the Commonwealth of Puerto Rico)

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KPMG LLP
American International Plaza
Suite 1100
250 Muñoz Rivera Avenue
San Juan, PR 00918-1819

Independent Auditors' Report

To the Retirement Board of the Government of Puerto Rico
Employees' Retirement System of
the Government of the Commonwealth of Puerto Rico:

We have audited the accompanying financial statements of the Employees' Retirement System of the Government of the Commonwealth of Puerto Rico (the System), which comprises the statement of fiduciary net position as of June 30, 2017, the related statement of changes in fiduciary net position for the year then ended, and the related notes to the financial statements, which collectively comprise the System's basic financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the fiduciary net position of the Employees' Retirement System of the Government of the Commonwealth of Puerto Rico as of June 30, 2017, and the changes in its fiduciary net position for the year then ended, in accordance with U.S. generally accepted accounting principles.



Emphasis of Matters

Uncertainty about Ability to Continue as a Going Concern

The accompanying financial statements have been prepared assuming that the System will continue as a going concern. As discussed in notes 3 and 14 to the basic financial statements, the System is severely underfunded, sold its remaining investments in the aggregate amount of approximately \$297 million, and started operating on a pay as you go basis in fiscal year 2018. Additionally, on May 3, 2017 and May 22, 2017, the Financial Oversight and Management Board commenced cases for the Commonwealth of Puerto Rico and the System, respectively, by filing petitions for relief under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act with the United States District Court for Puerto Rico. Accordingly, management of the System has stated that substantial doubt exists about the System's ability to continue as a going concern. Management's evaluation of the events and conditions and management's plans regarding these matters are also included in note 3. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

U.S. generally accepted accounting principles require that the management's discussion and analysis on pages 3–14 and the schedules in pages 75–81 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

KPMG LLP

San Juan, Puerto Rico
June 29, 2020

Stamp No. E403599 of the Puerto Rico
Society of Certified Public Accountants was
affixed to the record copy of this report.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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(A Component Unit of the Commonwealth of Puerto Rico)
Management's Discussion and Analysis (Unaudited)
June 30, 2017

Introduction

The following discussion and analysis of the financial performance of the Employees' Retirement System of the Government of the Commonwealth of Puerto Rico (the System) provides an overview of its activities for the fiscal year ended June 30, 2017. Its purpose is to provide explanations and insights into the information presented in the basic financial statements and required supplementary information. This discussion and analysis is intended to be read in conjunction with the System's financial statements.

The System is a trust created by the Legislature of the Commonwealth of Puerto Rico (the Legislature) in 1951 pursuant to Act No. 447 of May 15, 1951, as amended, to provide pension and other benefits to retired employees of the Commonwealth of Puerto Rico (the Commonwealth), its public corporations and municipalities. Prior to August 23, 2017, the System was administered by the Puerto Rico Government Employees and Judiciary Retirement Systems Administration (the ERS and JRS Administration) and governed by a board of trustees (the Board of Trustees).

Prior to August 23, 2017, the System administered a cost-sharing, multi-employer, pension plan consisting of three benefit structures: (i) a cost-sharing, multi-employer, defined benefit program, (ii) a defined contribution program (System 2000 program), and (iii) a contributory hybrid program. The System also administered post-employment healthcare benefits provided by the Commonwealth to retired plan members (Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities Medical Insurance Plan Contribution – ERS MIPC).

The System is considered an integral part of the financial reporting of the Commonwealth and is included in the Commonwealth's basic financial statements as a pension trust fund.

Overview of the Basic Financial Statements

The following discussion and analysis is intended to serve as an introduction to the System's basic financial statements. The basic financial statements are prepared in accordance with U.S. generally accepted accounting principles (GAAP) as applicable to governmental organization per Governmental Accounting Standards Board (GASB) pronouncements and include the following:

- The Statement of Fiduciary Net Position presents the financial position of the System at fiscal year-end. It provides information about the nature and amounts of resources with present service capacity that the System presently controls (assets), consumption of net assets by the System that is applicable to a future reporting period (deferred outflow of resources), presents obligations to sacrifice resources that the System has little or no discretion to avoid (liabilities), and acquisition of net assets by the System that is applicable to a future reporting period (deferred inflow of resources) with the difference between assets/deferred outflow of resources and liabilities/deferred inflow of resources being reported as net position. Investments are shown at fair value. All other assets and liabilities are determined on an accrual basis.
- The Statement of Changes in Fiduciary Net Position presents the results of activities during the fiscal year. All changes affecting the assets/deferred outflow of resources and liabilities/deferred inflow of resources of the System are reflected on an accrual basis of when the activity occurred, regardless of the timing of the related cash flows. Changes in the fair values of investments are included in the year's activity as net appreciation (depreciation) in fair value of investments.

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- The Notes to the Basic Financial Statements – provide additional information that is essential to a full understanding of the data provided in the financial statements. The notes present information about the System's accounting policies, significant account balances and activities, material risks, obligations, contingencies, and subsequent events, if any.

Required Supplementary Information is presented after the notes to the basic financial statements. Such information, although not a part of the basic financial statements, is required by the GASB. It consists of information pertaining to the System's actuarial methods and assumptions and provides data on changes in the employers' net pension liability and related ratios, the pension benefits employers' contributions, and the pension benefits' investment return as well as data on the System's other postemployment benefits.

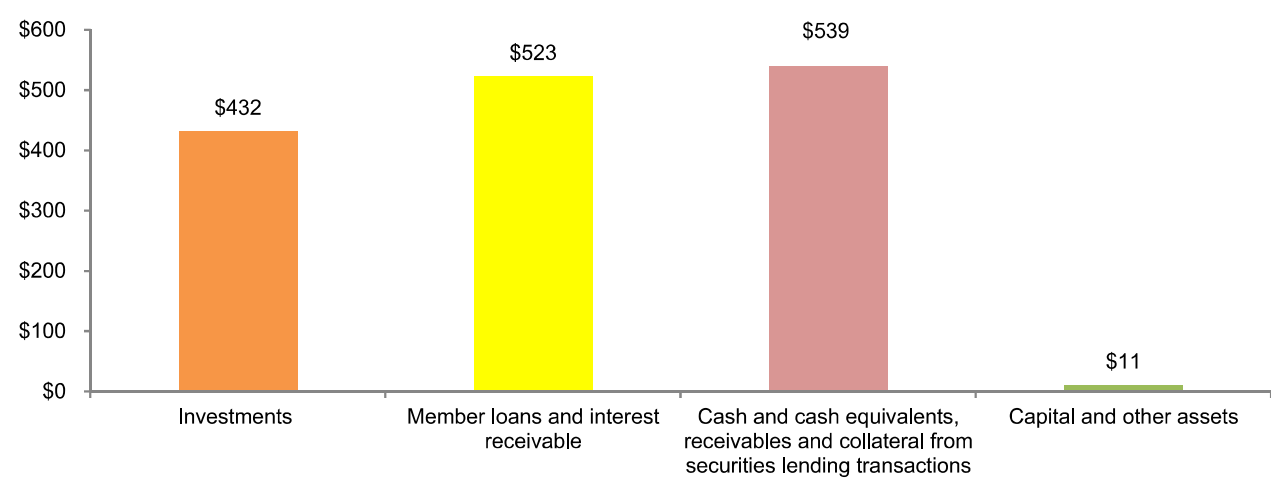
Financial Highlights

Prior to August 23, 2017, the System provided retirement benefits to employees of the Commonwealth, its public corporations and municipalities. The System's total assets as of June 30, 2017 and 2016 amounted to approximately \$1,505 million and \$2,284 million, respectively.

As of June 30, 2017, the System's total assets consisted of the following:

- \$345 million of investments in bonds, stocks and non-exchange commingled trust funds
- \$87 million in investments in limited partnerships
- \$523 million in member loans and interest receivable
- \$539 million in cash and cash equivalents, receivables and collateral from securities lending transactions.
- \$11 million in capital and other assets

The System's total assets as of June 30, 2017 are presented in the following chart (in millions):

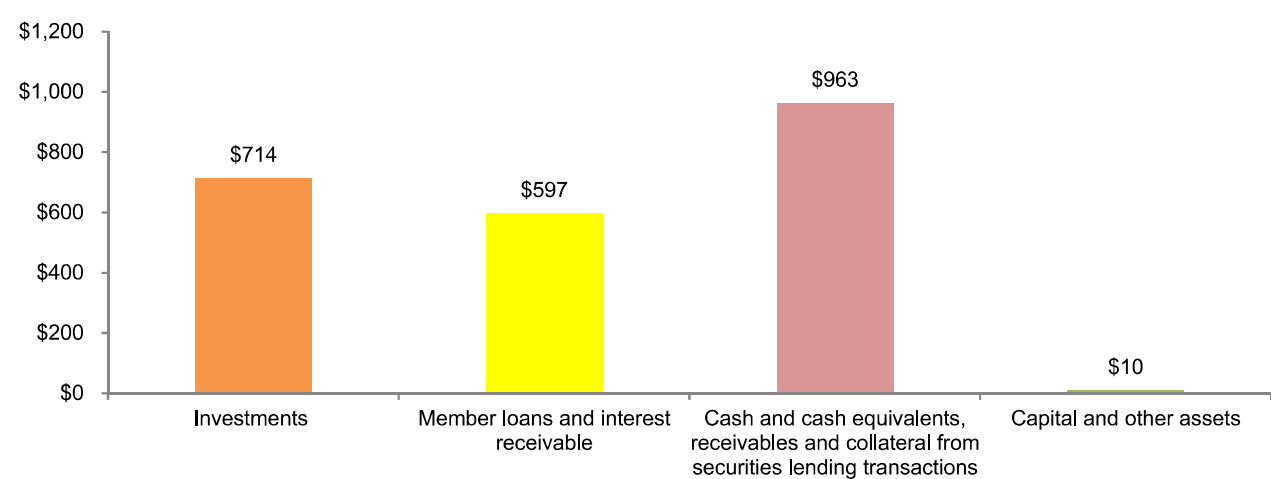


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As of June 30, 2016, the System’s total assets consisted of the following:

- \$667 million of investments in bonds, stocks and non-exchange commingled trust funds
- \$47 million in investments in limited partnerships
- \$597 million in member loans and interest receivable
- \$963 million in cash and cash equivalents, receivables and collateral from securities lending transactions.
- \$10 million in capital and other assets

The System’s total assets as of June 30, 2016 are presented in the following chart (in millions):



- The System has been in a deficit position since fiscal year 2015. The System’s total liabilities exceeded total assets, representing a fiduciary net deficit position of approximately \$2,109 million as of June 30, 2017, compared with fiduciary net position of approximately \$1,266 million as of June 30, 2016.
- The plan’s fiduciary net deficit position as a percentage of the total pension liability was negative 7.01% at June 30, 2017 and negative 3.47% at June 30, 2016.
- The medical insurance plan contribution, which constitutes the other postemployment healthcare benefits, is financed by the Commonwealth on a pay-as-you-go basis and consequently is unfunded.

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The following schedules present comparative summary financial statements of the System's fiduciary net position and changes in fiduciary net position for fiscal years 2017 and 2016:

Comparative Summary of Fiduciary Net Position – Pension Benefits

| | <u>2017</u> | <u>2016</u> | <u>Total dollar change</u> | <u>Total percentage change</u> |
|---|-----------------------|------------------------|------------------------------------|--|
| | | (Dollars in thousands) | | |
| Assets: | | | | |
| Cash and cash equivalents, receivables-net and collateral from securities lending transactions | \$ 538,520 | 962,706 | (424,186) | (44.1)% |
| Investments | 431,955 | 714,214 | (282,259) | (39.5) |
| Member loans and interest receivable – net | 523,443 | 596,997 | (73,554) | (12.3) |
| Capital assets and other | <u>10,718</u> | <u>10,487</u> | <u>231</u> | <u>2.2</u> |
| Total assets | <u>1,504,636</u> | <u>2,284,404</u> | <u>(779,768)</u> | <u>(34.1)</u> |
| Liabilities: | | | | |
| Accounts payable and accrued liabilities | 279,366 | 104,315 | 175,051 | 167.8 |
| Bond interest payable | 14,076 | 14,094 | (18) | (0.1) |
| Payable for investment securities purchased | — | 1,609 | (1,609) | (100.0) |
| Securities lending obligations | 7,359 | 19,754 | (12,395) | (62.7) |
| Due to Commonwealth of Puerto Rico | 98,044 | 91,474 | 6,570 | 7.2 |
| Escrow funds of mortgage loans and guarantee insurance reserve for loans to plan members | 11,018 | 10,467 | 551 | 5.3 |
| Accrued Investment Expense | 541 | — | 541 | 100.0 |
| Bonds payable | 3,166,472 | 3,134,902 | 31,570 | 1.0 |
| Other liabilities | <u>36,613</u> | <u>173,674</u> | <u>(137,061)</u> | <u>(78.9)</u> |
| Total liabilities | <u>3,613,489</u> | <u>3,550,289</u> | <u>63,200</u> | <u>1.8</u> |
| Net position (deficit) | \$ <u>(2,108,853)</u> | <u>(1,265,885)</u> | <u>(842,968)</u> | <u>66.6%</u> |

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Comparative Summary of Changes in Fiduciary Net Position – Pension Benefits

| | <u>2017</u> | <u>2016</u> | <u>Total dollar change</u> | <u>Total percentage change</u> |
|-------------------------------|-----------------------|------------------------|------------------------------------|--|
| | | (Dollars in thousands) | | |
| Additions: | | | | |
| Contributions: | | | | |
| Employer contributions: | | | | |
| Basic benefits | \$ 726,911 | 582,803 | 144,108 | 24.7% |
| Special benefits | 194,626 | 196,674 | (2,048) | (1.0) |
| Member contributions | 320,095 | 333,633 | (13,538) | (4.1) |
| Net investment income | 28,155 | 37,345 | (9,190) | (24.6) |
| Other income | 56,626 | 52,791 | 3,835 | 7.3 |
| Total additions | <u>1,326,413</u> | <u>1,203,246</u> | <u>123,167</u> | <u>10.2</u> |
| Deductions: | | | | |
| Benefits paid to participants | 1,524,695 | 1,532,640 | (7,945) | (0.5) |
| Refunds of contributions | 35,229 | 34,937 | 292 | 0.8 |
| Interest on bonds payable | 198,084 | 196,211 | 1,873 | 1.0 |
| General and administrative | 24,358 | 27,670 | (3,312) | (12.0) |
| Other expenses | 387,015 | 9,401 | 377,614 | 4,016.7 |
| Total deductions | <u>2,169,381</u> | <u>1,800,859</u> | <u>368,522</u> | <u>20.5</u> |
| Net decrease in net position | (842,968) | (597,613) | (245,355) | 41.1 |
| Net position (deficit): | | | | |
| Beginning of year | <u>(1,265,885)</u> | <u>(668,272)</u> | <u>(597,613)</u> | <u>89.4</u> |
| End of year | \$ <u>(2,108,853)</u> | <u>(1,265,885)</u> | <u>(842,968)</u> | <u>66.6%</u> |

Going Concern

The discussion in note 3 to the financial statements provides information regarding the System's going concern uncertainty.

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As of June 30, 2017, the System was a mature retirement system with a significant retiree population. The System's net pension liability and the fiduciary net deficit position as a percentage of the total pension liability (the funded ratio) as of June 30, 2017, are approximately \$32,201 million and negative 7.01%, respectively. The System had been in a deficit position since fiscal year 2015. Based on the statutory funding requirements, the annual benefit payments and administrative expenses paid by the System were significantly larger than the member and employers' contributions to the System. Due to the small asset base, investment income was insufficient to cover the negative cash flow. Illiquid assets (total receivables, member loans and related interest receivable, COFINA investment and investments in limited partnership) amounted to approximately \$723 million or 48% of the System's total assets as of June 30, 2017.

As described in notes 3 and 14 to the financial statements, in July 2017, the System sold investments amounting to approximately \$297 million and transferred approximately \$190 million of the net proceeds to the Treasury Department as required under Joint Resolution 188.

On June 30, 2016, the U.S. Congress enacted the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), which automatically put into effect a temporary stay of all debt-related litigation against the Commonwealth and its covered instrumentalities, including the System, pursuant to section 405 of PROMESA (the Title IV Stay). On May 1, 2017, the Title IV Stay expired, permitting substantial litigation to resume against the Commonwealth and its covered instrumentalities, including the System. On May 3, 2017, the Financial Oversight and Management Board for Puerto Rico established under PROMESA (the Oversight Board), at the request of the Governor of Puerto Rico (the Governor), commenced a Title III case for the Commonwealth by filing a petition for relief under Title III of PROMESA in the United States District Court for the District of Puerto Rico (the Title III Court). On May 21, 2017, the Oversight Board, at the request of the Governor, commenced a Title III case for the System by filing a similar petition for relief under Title III of PROMESA in the Title III Court.

On August 23, 2017, the Commonwealth enacted the Act to Guarantee the Payment to Our Pensioners and Establish a New Plan for Defined Contributions for Public Servants (Act 106-2017), which completely changed the System by, among other things, (i) replacing the governing boards of the System, the Retirement System for the Judiciary of the Commonwealth of Puerto Rico (JRS), and the Puerto Rico System of Annuities and Pensions for Teachers (TRS, and collectively with the System and JRS, the Retirement Systems) with a single Retirement Board of the Commonwealth of Puerto Rico (the Retirement Board) and (ii) implementing a "pay-as-you-go" (PayGo) method for the payment of pension benefits by the Commonwealth rather than the System. Act 106-2017 created the legal framework for the Commonwealth to guarantee payments to pensioners through the PayGo system.

Comparative Summary of Fiduciary Net Position Analysis – Pension Benefits

The basic financial statements of the System for the fiscal year ended June 30, 2017, present a decrease in net position of approximately \$843 million, resulting in a net deficit position of approximately \$2,109 million as of June 30, 2017, compared with a deficit net position of approximately \$1,266 million as of June 30, 2016. The decrease in the net position (increase in deficit) in fiscal year 2017 resulted from the excess of deductions, mainly other expenses and benefits paid to participants, over additions, mainly contributions from participating employers and employees. The decrease in net position is mainly caused by a decrease in employer contributions receivable of approximately \$204 million in fiscal year 2017.

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Total contributions from participating employers and members increased by approximately \$129 million, from \$1,113 million during fiscal year 2016 to approximately \$1,242 million during fiscal year 2017. Total net investment and securities lending transaction income decreased by approximately \$9 million, from approximately \$37 million during fiscal year 2016 to approximately \$28 million during fiscal year 2017. The System recognized a net depreciation in the fair value of investments of approximately \$8 million during fiscal year 2017, compared with a net appreciation in the fair value of investments of approximately \$900 thousand recognized in fiscal year 2016. Also, the System recognized an impairment loss on deposits with a governmental bank of approximately \$21 million in fiscal year 2016 and \$9 million in fiscal year 2017 (refer to note 6 to the financial statements).

Total deductions increased by approximately \$369 million in fiscal year 2017, mainly as a result of the increase of approximately \$378 million in other expenses and the decrease of approximately \$8 million in benefits paid to participants. Benefits paid to participants amounted to approximately \$1,525 million for fiscal year 2017 and approximately \$1,533 million for fiscal year 2016. General and administrative expenses amounted to approximately \$24 million for fiscal year 2017 and approximately \$28 million for fiscal year 2016.

During fiscal year 2007, the Board of Trustees approved the issuance of bonds payable to increase the funds available to pay pension benefits to certain beneficiaries and to reduce the unfunded accrued actuarial liability. As of June 30, 2017, bonds payable amounted to approximately \$3,166 million.

Other Post-employment Healthcare Benefits

Other post-employment healthcare benefits paid during fiscal year 2017 amounted to approximately \$91.2 million, a decrease of approximately \$2.8 million or 3% as compared to the \$93.7 million paid during fiscal year 2016. Effective July 1, 2013, no benefits are provided to new retirees, as required by Act No. 3 of 2013.

Financial Analysis of the System

As of June 30, 2017 and 2016, the System held approximately \$523 million and \$597 million, respectively, in loans and interest receivable from plan members, which represents 55% and 46%, respectively, of the total investment portfolio, including loans. As of June 30, 2017, member loans and interest receivable consisted of \$161 million in mortgage loans, \$299 million in personal loans, \$37 million in cultural trip loans, and \$29 million in interest receivable, less \$3 million in allowance for adjustments and losses in realization. As of June 30, 2016, member loans and interest receivable consisted of \$170 million in mortgage loans, \$351 million in personal loans, \$45 million in cultural trip loans, and \$34 million in interest receivable, less \$3 million in allowance for adjustments and losses in realization. As of June 30, 2017, and 2016, the fair value of the System's investment in limited partnerships amounted to approximately \$87 million and \$47 million, respectively, which represented approximately 9% and 4% of the investment portfolio, as of June 30, 2017 and 2016, respectively.

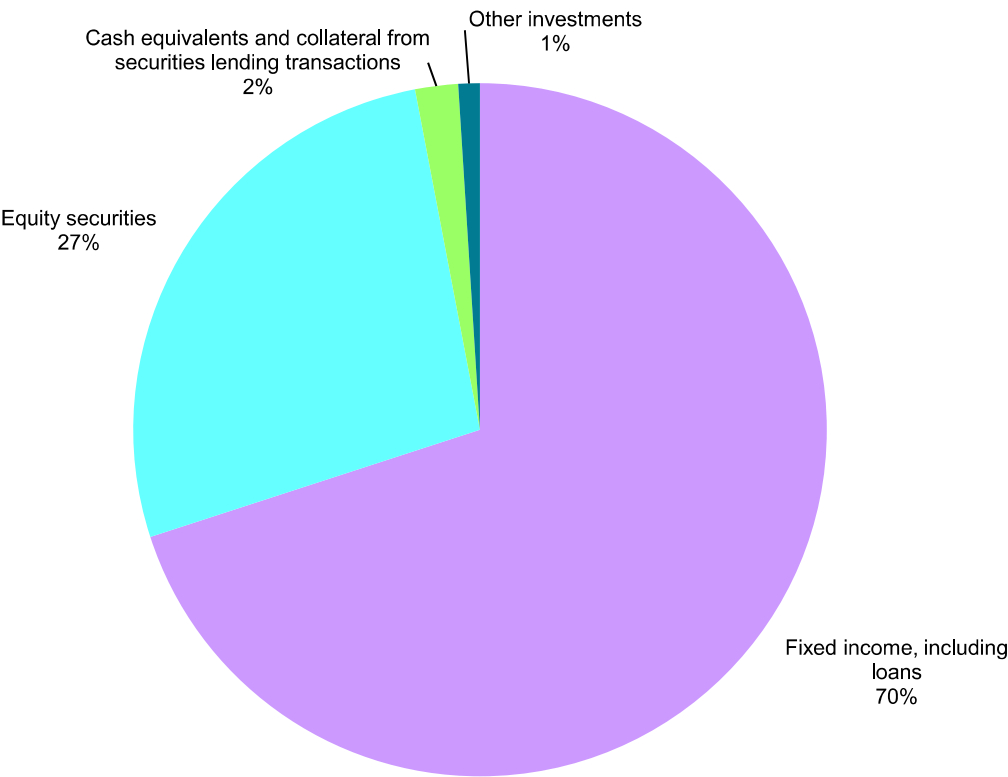
The System earns additional investment income by lending investment securities to brokers via its custodian's securities lending program. The brokers provide collateral to the System and generally use the borrowed securities to cover short sales and failed trades. The cash collateral received from the brokers is invested in a short-term investment fund in order to earn interest. For the years ended June 30, 2017 and 2016, net income from the securities lending activity amounted to approximately \$30,000 and \$113,000, respectively.

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Investment Portfolio and Capital Markets Overview

The System’s total investment assets, including member loans, collateral from securities lending transactions and cash equivalents (investment portfolio, including loans), as of June 30, 2017 totaled approximately \$979 million. Member loans amounted to \$523 million as of June 30, 2017.

As of June 30, 2017, the System’s investment portfolio allocation, including member loans, was 70% in fixed-income investments, including loans receivable, 27% in equity securities, 2% in cash and short-term investments, and 1% in other investments as shown in the following chart:



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Economy and Capital Markets Overview

United States Equity Overview for the fiscal year 2017: As of June 30, 2017, the S&P 500 was near a record high, up almost 15% since the U.S. presidential election in November 2016. It was the 26th new high in calendar year 2017. The market growth during this period was led by technology and financial stocks. Most of the economic statistics in the U.S. remained strong and were improving globally. The 2017 fiscal year concluded with a quarter-point rate hike by the Federal Reserve as they remained committed to their plan to normalize monetary policy.

International Equity Overview for the Fiscal year 2017: International equity markets were the best performers for fiscal year 2017. The ACWI ex US index was up 20.5% in U.S. dollar terms and emerging markets were up almost 24% for the trailing 12 months. All global regions participated in this growth, led by over 26% growth among developed, small-capitalized companies and with very few countries up less than 10%. Unlike the United States, the developed market growth index lagged the developed market value index for the prior year.

United States Fixed Income Overview for the Fiscal Year 2017: U.S. Treasuries, TIPS and municipal positions were all slightly negative for fiscal year 2017. High yield was the strong positive outlier up over 12%. Investment grade managers performed well if they participated more heavily in the credit sectors as spreads tightened across all credit qualities. Many non-dollar debt positions benefited with dollar weakness creating outsized performance in a more globally diverse fixed income portfolio.

Total Fund Performance

The total fund (excluding GDB cash) earned 6.5% net of investment manager fees for fiscal year 2017. The results were disappointing as the market had performed strongly since the U.S. presidential election in November 2016, but the System was not able to fully participate. Less than one-third of the remaining assets were liquid. The majority of the assets, approximately \$523 million, were in the current employee and retiree loan program. The asset allocation plan adopted in fiscal year 2016 was never fully implemented. With the change in the System administration, a decision was made to use the remaining liquid assets to fund benefit payments.

Over the fiscal year, the investment fund had net cash out flows of approximately \$416 million. These outflows were largely used for benefit payments and represent 33% of the beginning year balance.

Though the System was not able to fully take advantage of the strong equity market returns during this fiscal year with the need to raise substantial cash, the fund did earn 6.5% resulting in approximately \$69 million in additional gains to the portfolio. As the liquid assets are removed, the focus will be two-fold. One, how to best manage the illiquid investments to maximize the benefit to the plan and two, how the entity must continue to service its members.

Other Investments and Member Loans Transactions

As of June 30, 2017, the System held approximately \$523 million in member loans which represented 55% of the total investment portfolio, including loans. Member loan balances as of June 30, 2017 were \$74 million lower than a year ago.

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At the end of the 2017 fiscal year, the System had some exposure to limited partnerships of private equity investments valued at approximately \$87 million, which represented 9% of the System's total investment portfolio, including member loans.

Funding Status

The System was created by Act No. 447 of May 15, 1951 (Act No. 447) and, since its inception, lacked proper planning and funding. The levels of contributions were relatively low in comparison to the level of benefits. As more people joined the government labor force and then retired under the different benefit structures, the gap between the assets available to pay benefits and the actuarial obligation started its steeping course.

During fiscal year 2007, the Board of Trustees approved the issuance of bonds in an effort to increase the funds available to pay pension benefits and to reduce the unfunded accrued actuarial pension liability. In connection with the Bonds, the System pledge employers contributions, as defined in the ERS Bond Resolution, made after the date of issuance of the first series of Bonds to the payment of the Bonds, invested the proceeds of the Bonds, and used these investments and the earnings thereon to provide pension benefits to beneficiaries. Specifically, on January 31, 2008, the System issued the first series of the Bonds, which consisted of approximately \$1,589 million aggregate principal amount of Senior Pension Funding Bonds, Series A. On June 2, 2008, the System issued the second of such series of Bonds, which consisted of approximately \$1,059 million aggregate principal amount of Senior Pension Funding Bonds, Series B. Finally, on June 30, 2008, the System issued the third and final of such series of Bonds, which consisted of approximately \$300 million aggregate principal amount of Senior Pension Funding Bonds, Series C.

Despite these efforts, the System's actuarial obligation continued its increasing trend as a result of the growth in the size and longevity of the pensioner population and the fact that incoming pensioners were entitled to even higher annuities based on their higher salaries.

Prior to fiscal year 2017, the Commonwealth enacted a series of laws to deal with the funding issues that the System experienced. For example, in 2011, the Commonwealth enacted Law 116 to increase the employers' contribution rate from 9.275% to 10.275% of employee compensation for the 2011-2012 fiscal year, 1% annually for each of the next four years, and 1.25% annually for each of the five years thereafter, capped at an aggregate contribution rate of 20.525% effective July 1, 2020. Other measures taken to improve the System's funding, included: (1) improving the collection of late contributions by receiving such contributions directly from the Municipal Revenue Collection Center (known as CRIM by its Spanish acronym) when a municipality fails to send their contributions within 30 days from the due date or from the Department of Treasury of the Commonwealth in the case of public corporations; (2) implementation of Act No. 70 establishing early retirement incentives; (3) revision of the Employee Personal Loan Policy by reducing personal and cultural loan amounts to \$5,000 each, from \$15,000 and \$10,000, respectively; and (4) the receipt of approximately \$162.5 million in bonds issued by the Puerto Rico Sales Tax Financing Corporation (known as COFINA by its Spanish acronym).

In 2013, the Commonwealth enacted Law 3 that reformed the System by, among other measures, reducing benefits, increasing employee contributions, and, in the case of active employees who were entitled to the defined benefits program, replacing most of the defined benefit elements of the system with a defined contribution system. Based on the statutory funding requirements prior to this reform, the annual benefit

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payments and administrative expenses of the System were significantly larger than the member and employer contributions made to the System.

Act No. 3 2013 amended Act No. 447, Act No. 1 of 1990 (Act No. 1) and Act No. 305 to establish, among other things, a defined contribution program similar to the System 2000 Program (the Contributory Hybrid Program) to be administered by the System. All regular employees hired for the first time on or after July 1, 2013, became part of the Contributory Hybrid Program. Also, Act No. 3 froze all retirement benefits accrued through June 30, 2013 under the Defined Benefit Program, and thereafter, all future benefits accrued under the defined contribution formula used for the 2000 System Program participants. Ceasing future defined benefit accruals under Act No. 447 and Act No. 1 and converting to a member-funded hybrid plan resulted in lower benefit payments.

On June 27, 2017, the Treasury Department issued Circular Letter No. 1300-46-17 in order to convey to the Commonwealth central government agencies, public corporations and municipalities the procedures to adopt, effective, July 1, 2017, the new "pay-as-you-go" (PayGo) system. With the start of the fiscal year 2018, employers' contributions, contributions ordered by special laws, and the Additional Uniform Contribution were eliminated. A monthly PayGo charge was implemented to cover the actual cost of pension payments and that is remitted by the aforementioned government entities to pay benefits to their respective retirees. The System helps determine and administer the payment amount per each current retiree that is charged to each Commonwealth central government agency, public corporation and municipality.

On August 23, 2017, the Governor signed into law Act 106-2017, which created the legal framework for the Commonwealth to guarantee payments to pensioners through the PayGo system. Among other things, Act 106-2017 also created a Defined Contribution Plan for current employees under which future benefits will not accumulate.

At June 30, 2017, the System's pension plan consisted of three different benefit structures, which were administrated according to the specifications in each applicable pension benefit law. For all plan members, employee contributions range from 8.275% to 10% of their salary, as specified by the employee. Under all structures, employers' contributions during the fiscal year ended June 30, 2017 were 15.275% of the employee salary. Based on the last actuarial valuation at June 30, 2017, the employers' net pension liability amounted to approximately \$32,201 million, with a plan fiduciary net deficit position as a percentage of the total pension liability of negative 7.01%. The liability for postemployment healthcare benefits amounted to approximately \$1,138 million as of June 30, 2017 and was fully unfunded.

Capital Assets

The total aggregate amount of the System's investment in capital assets (net of accumulated depreciation) was approximately \$9.9 million and \$9.7 million as of June 30, 2017 and June 30, 2016, respectively. Capital assets include land, building and improvements, construction in progress, and equipment. Building and improvements consist of the facilities in which the System conducts its operations.

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Debt Administration

Long-term debt obligations include the System's senior funding bonds and amounted to approximately \$3,166 million and \$3,135 million as of June 30, 2017 and 2016, respectively. The System has issued three series of revenue bonds designated as "Senior Pension Funding Bonds", the proceeds of which were used mainly to increase the funds available to pay pension benefits to certain of its beneficiaries and reduce its unfunded actuarial accrued liability. The Bonds are limited, nonrecourse obligations of the System, payable solely from and secured solely by a pledge of employer contributions, as defined in the ERS Bond Resolution, made after the date of issuance of the first series of Bonds, and from funds held on deposit with the Bank of New York Mellon (the Fiscal Agent). The Bonds are not payable from contributions made to the System by participating employees, or from the assets acquired with the proceeds of the Bonds, or from employer contributions released by the Fiscal Agent to the System after funding of required reserves, or from any other assets of the System. These bonds are currently rated "C" by Moody's Investors Service and "CC" by Standard & Poor's Ratings Services. Refer to note 10 to the basic financial statements for further information regarding the System's long-term obligations. For the suspension of the monthly payments to the trustee of the System's bonds, refer to note 14 of the basic financial statements.

Requests for Information

This financial report is designed to provide a general overview of the System's finances, comply with related laws and regulations, and demonstrate commitment to public accountability. Questions concerning any of the information provided in this report or requests for additional information should be addressed to the Commonwealth of Puerto Rico Government Employees and Judiciary Retirement Systems Administration, Avenida Jose de Diego, Parada 22 Centro Gubernamental Minillas, Edificio Torre Norte, Piso 11, San Juan, Puerto Rico, 00940.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
(A Component Unit of the Commonwealth of Puerto Rico)

Statement of Fiduciary Net Position

June 30, 2017

(In thousands)

| | Pension | Post employment healthcare benefits | Total |
|--|----------------|--|--------------|
| Assets: | | | |
| Cash and cash equivalents: | | | |
| Deposits at commercial banks: | | | |
| Unrestricted | \$ 257,879 | — | 257,879 |
| Restricted | 202,295 | — | 202,295 |
| Money market funds: | | | |
| Unrestricted | 2,340 | — | 2,340 |
| Restricted | 13,279 | — | 13,279 |
| U.S. Treasury bill – restricted | 909 | — | 909 |
| Total cash and cash equivalents | 476,702 | — | 476,702 |
| Receivables, net: | | | |
| Employers – net of allowance for uncollectible accounts of \$1,029,739 | 36,172 | — | 36,172 |
| Due from Retirement System for the Judiciary of the Commonwealth of Puerto Rico | 627 | — | 627 |
| Investments sold | 401 | — | 401 |
| Other | 17,259 | — | 17,259 |
| Total receivables, net | 54,459 | — | 54,459 |
| Collateral from securities lending transactions | 7,359 | — | 7,359 |
| Investments: | | | |
| Bonds and notes | 163,187 | — | 163,187 |
| Nonexchange commingled trust funds | 181,699 | — | 181,699 |
| Investments in limited partnerships | 87,069 | — | 87,069 |
| Total investments | 431,955 | — | 431,955 |
| Member loans and interest receivable – net | 523,443 | — | 523,443 |
| Capital assets – net | 9,902 | — | 9,902 |
| Other assets | 816 | — | 816 |
| Total assets | 1,504,636 | — | 1,504,636 |

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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(A Component Unit of the Commonwealth of Puerto Rico)

Statement of Fiduciary Net Position

June 30, 2017

(In thousands)

| | Pension | Post employment healthcare benefits | Total |
|--|----------------|--|-------------|
| Liabilities: | | | |
| Accounts payable and accrued liabilities | \$ 279,366 | — | 279,366 |
| Bond interest payable | 14,076 | — | 14,076 |
| Securities lending obligations | 7,359 | — | 7,359 |
| Due to Commonwealth of Puerto Rico | 98,044 | — | 98,044 |
| Escrow funds of mortgage loans and guarantee insurance reserve for member loans | 11,018 | — | 11,018 |
| Accrued Investment Expense | 541 | — | 541 |
| Bonds payable | 3,166,472 | — | 3,166,472 |
| Other liabilities | 36,613 | — | 36,613 |
| Total liabilities | 3,613,489 | — | 3,613,489 |
| Contingencies (note 13) | — | — | — |
| Unrestricted net deficit position | \$ (2,108,853) | — | (2,108,853) |

See accompanying notes to basic financial statements.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
(A Component Unit of the Commonwealth of Puerto Rico)

Statement of Changes in Fiduciary Net Position

Year ended June 30, 2017

(In thousands)

| | <u>Pension</u> | <u>Post employment healthcare benefits</u> | <u>Total</u> |
|--|-----------------------|--|--------------------|
| Additions: | | | |
| Contributions: | | | |
| Employer contributions: | | | |
| Basic benefits, net of provision for uncollectible contributions of \$405,661 | \$ 726,911 | — | 726,911 |
| Special benefits | 194,626 | 91,280 | 285,906 |
| Member contributions | <u>320,095</u> | <u>—</u> | <u>320,095</u> |
| Total contributions | <u>1,241,632</u> | <u>91,280</u> | <u>1,332,912</u> |
| Investment income: | | | |
| Net depreciation in fair value of investments | (7,856) | — | (7,856) |
| Impairment loss on deposits with governmental bank (note 6) | (9,218) | — | (9,218) |
| Interest | 46,800 | — | 46,800 |
| Dividends | 253 | — | 253 |
| Less investment expense, other than from securities lending | <u>(1,854)</u> | <u>—</u> | <u>(1,854)</u> |
| Net income from investing, other than from securities lending | 28,125 | — | 28,125 |
| Securities lending income | <u>30</u> | <u>—</u> | <u>30</u> |
| Net investment income | 28,155 | — | 28,155 |
| Other income | <u>56,626</u> | <u>—</u> | <u>56,626</u> |
| Total additions | <u>1,326,413</u> | <u>91,280</u> | <u>1,417,693</u> |
| Deductions: | | | |
| Benefits paid to participants: | | | |
| Annuities | 1,320,005 | — | 1,320,005 |
| Special benefits | 194,626 | 91,280 | 285,906 |
| Death benefits | 10,064 | — | 10,064 |
| Refunds of contributions | 35,229 | — | 35,229 |
| Interest on bonds payable | 198,084 | — | 198,084 |
| General and administrative | 24,358 | — | 24,358 |
| Other expenses | <u>387,015</u> | <u>—</u> | <u>387,015</u> |
| Total deductions | <u>2,169,381</u> | <u>91,280</u> | <u>2,260,661</u> |
| Net decrease in net position | (842,968) | — | (842,968) |
| Net position (deficit): | | | |
| Beginning of year | <u>(1,265,885)</u> | <u>—</u> | <u>(1,265,885)</u> |
| End of year | <u>\$ (2,108,853)</u> | <u>—</u> | <u>(2,108,853)</u> |

See accompanying notes to basic financial statements.

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June 30, 2017

(1) Organization

The Employees' Retirement System of the Government of the Commonwealth of Puerto Rico (the System) is a trust created by the Legislature of the Commonwealth of Puerto Rico (the Legislature) pursuant to Act No. 447 on May 15, 1951 (Act No. 447), as amended, to provide pension and other benefits to retired employees of the Commonwealth, its public corporations and municipalities. Prior to August 23, 2017, the System administered a cost-sharing, multi-employer, pension plan (the pension plan). The System also administers post-employment healthcare benefits provided by the Commonwealth of Puerto Rico (the Commonwealth) to retired plan members (the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities Medical Insurance Plan Contribution – ERS MIPC), an unfunded, cost-sharing, multi-employer defined benefit other postemployment benefit plan.

The System is considered an integral part of the Commonwealth's financial reporting entity and is included in the Commonwealth's basic financial statements as a pension trust fund. The System, is a governmental retirement plan, and as such is excluded from the provisions of the Employee Retirement Income Security Act of 1974 (ERISA). Income earned by the System is not subject to Federal and Puerto Rico taxes.

Under Act No. 447, until August 23, 2017, the System was governed by an 11-member board of trustees (the Board of Trustees), composed of (i) four ex-officio members (or their designees): the Secretary of Treasury of the Commonwealth, the President of the Government Development Bank for Puerto Rico (GDB), the Commissioner of Municipal Affairs, and the Director of the Office of Human Resources of the Commonwealth; (ii) three members appointed to three-year terms by the Governor of the Commonwealth (the Governor), two of whom had to be members of the System and one member of the Retirement System for the Judiciary of the Commonwealth of Puerto Rico (JRS), each with at least ten years of credited service; (iii) two members who had to be pensioners of the System and JRS, respectively; (iv) the President of the Federation of Mayors; and (v) the President of the Association of Mayors. As of June 30, 2017, the System was governed by the Board of Trustees.

On August 23, 2017, Act 106-2017 dissolved the Board of Trustees and established a new Retirement Board of the Government of Puerto Rico (the Retirement Board), to govern all of the Commonwealth's Retirement Systems, including the System. The Retirement Board is comprised of 13 members, composed of (i) six ex-officio members (or their designees): the Executive Director of the Puerto Rico Fiscal Agency and Financial Advisory Authority (FAFAA), the Secretary of Treasury of the Commonwealth, the Director of the Office of Management and Budget, the Director of the Office for the Administration and Transformation of Human Resources of the Government of Puerto Rico, the President of the Federation of Mayors, and the President of the Association of Mayors; (ii) three Governor-appointed representatives of the teachers of the Department of Education, the public corporations, and the Judiciary Branch; and (iii) four additional Governor-appointed members as representatives of the public interest. As of the date of these financial statements, there are two vacancies in the Retirement Board. For additional information regarding Act 106-2017, refer to note 14 of the basic financial statements

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Prior to August 23, 2017, the System and the Retirement System for the Judiciary of the Commonwealth of Puerto Rico (JRS), also a component unit of the Commonwealth, were both administered by the Puerto Rico Government Employees and Judiciary Retirement Systems Administration (the ERS and JRS Administration). The ERS and JRS Administration allocated 97.93% of its general and administrative expenses to the System during the fiscal year ended June 30, 2017. The methodology used to determine the allocation is based on total employers' and participating employees' contributions to the System, divided by the aggregate total of employers' and participating employees' contributions to the System and JRS, combined.

(2) Summary of Significant Accounting Policies

The following are the significant accounting policies followed by the System in the preparation of its financial statements:

(a) Basis of Presentation

The accompanying financial statements have been prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles (GAAP) as applicable to governmental organizations per the Governmental Accounting Standards Board (GASB) pronouncements. Plan member contributions are recognized in the period in which the contributions are due. Employer contributions are recognized when due and the employer has legal requirement to provide the contributions. Benefits and refunds are recognized when legally due and payable.

(b) Use of Estimates

The preparation of the basic financial statements requires management to make significant estimates and assumptions relating to the reporting of assets and liabilities and in the disclosures of contingencies to prepare these financial statements in conformity with GAAP. The System's most significant estimates relate to the total pension liability, the allowance for uncollectible amounts of member loans and accounts receivable and the valuation of certain investments. Due to the inherent nature of these estimates, actual results could differ from those estimates.

(c) Cash and Cash Equivalents

Cash equivalents include all highly liquid debt instruments with original maturities of three months or less from the date of acquisition and consist of money market funds, U.S. Treasury bills, and certificates of deposit in GDB (a component unit of the Commonwealth) and in commercial banks. Restricted cash deposited with GDB consists of payments received from mortgage loan holders in the servicing of loans (escrow accounts), expired checks not claimed by the plan members restricted for repayments, and temporary amounts to be transferred to the Bank of New York Mellon (trustee) restricted for bond debt service requirements. Restricted money market funds consist of funds held by the trustee to maintain the debt service funds and the sinking funds for the repayment of the System's bonds payable.

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(d) Investments

Investments are reported at fair value. The fair value of investments is based on quoted prices, if available. The System has investments in limited partnerships and non-exchange commingled trust funds valued at approximately \$87 million and \$182 million, respectively, as of June 30, 2017. Fair values of investments in limited partnerships have been estimated in the absence of readily determinable fair values, based on information provided by the underlying fund managers. Non-exchange commingled trust funds are reported at their net asset value (NAV). The NAV includes the market value of the securities in the fund plus any receivables, payables, and accrued fund expenses.

Securities purchases and sales are recorded on a trade-date basis. Realized gains and losses from the sale of securities and unrealized changes in the fair value of outstanding securities are included in net appreciation (depreciation) in fair value of investments. Realized gains and losses are computed as the difference between the proceeds of the sale and the cost of the investment sold, determined by the average cost method. Interest income is recorded as earned on an accrual basis. Dividend income is recorded on the ex-dividend date.

(e) Member Loans

Mortgage, personal, and cultural trip loans to plan members are stated at their outstanding principal balance less an allowance for uncollectible amounts. The maximum amount that was loaned to plan members for mortgage loans is \$100,000 and \$5,000 for personal, and cultural trip loans.

At June 30, 2017, the System serviced mortgage loans with an aggregate principal balance of approximately \$161 million at June 30, 2017, related to certain mortgage loans sold to the Federal National Mortgage Association for a fee of 0.25%. The sale contract stipulates that the System must repurchase any loans with payments in arrears over 90 days.

(f) Guarantee Insurance Reserve for Member Loans

Premiums collected and benefits claimed are recorded as additions and deductions, respectively. The guarantee insurance reserve for life insurance on loans to plan members is revised each year and adjusted accordingly based on the annual higher claim amount of a five-year period increased by a management determined percentage.

(g) Capital Assets

Capital assets include building, building improvements, and furniture and equipment. The System defines capital assets as assets with an initial individual cost of \$500 or more at the date of acquisition and a useful life equal to or in excess of four years. Capital assets are recorded at historical cost, or their estimated historical cost, if actual historical costs are not available. Donated capital assets are recorded at their estimated fair value at time of donation.

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Capital assets are depreciated on the straight-line method over the assets estimated useful life. There is no depreciation recorded for construction in progress. The estimated useful lives of capital assets are as follows:

| | <u>Years</u> |
|--|--------------|
| Building | 50 |
| Buildings improvements | 10 |
| Equipment, furniture, fixtures, and vehicles | 5–10 |

(h) Termination Benefits

The System accounts for termination benefits in accordance with GASB Statement No. 47, *Accounting for Termination Benefits*. Pursuant to the provisions of GASB Statement No. 47, the System, as an employer, should recognize a liability and expense for voluntary termination benefits (for example, early retirement incentives) when the offer is accepted and the amount can be estimated. A liability and expense for involuntary termination benefits (for example, severance benefits) should be recognized when a plan of termination has been approved by those with the authority to commit the government to the plan, the plan has been communicated to the employees, and the amount can be estimated.

(i) Recently Issued Accounting Pronouncements

The following new accounting standards have been issued but are not yet effective during the fiscal year ending June 30, 2017:

- GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions (and Certain Issues Related to OPEB Plan Reporting)*. This Statement replaces the requirements of Statements No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as amended, and No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, for OPEB. This statement establishes new accounting and financial reporting requirements for OPEB plans. The provisions of this statement are effective for fiscal years beginning after June 15, 2017. The System is evaluating the impact of this new statement.
- GASB Statement No. 82, *Pension Issues – an Amendment of GASB Statements No 67, No. 68 and No. 73*. This Statement addresses certain issues that have been raised with respect to GASB Statements No. 67, No. 68, and No. 73. The Statement is designed to improve consistency in the application of the pension standards by clarifying or amending related areas of existing guidance. Specifically, this Statement addresses issues regarding (1) the presentation of payroll-related measures in required supplementary information, (2) the selection of assumptions and the treatment of deviations from the guidance in an Actuarial Standard of Practice for financial reporting purposes, and (3) the classification of payments made by employers to satisfy employee (plan member) contribution requirements. Prior to the issuance of this Statement, GASB Statements No. 67 and No. 68 required presentation of covered-employee payroll, which is

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the payroll of employees that are provided with pensions through the pension plan, and ratios that use that measure, in schedules of required supplementary information. This Statement amends GASB Statements No. 67 and No. 68 to instead require the presentation of covered payroll, defined as the payroll on which contributions to a pension plan are based, and ratios that use that measure. This Statement clarifies that a deviation, as the term is used in Actuarial Standards of Practice issued by the Actuarial Standards Board, from the guidance in an Actuarial Standard of Practice is not considered to be in conformity with the requirements of GASB Statement No. 67, GASB Statement No. 68, or GASB Statement No. 73 for the selection of assumptions used in determining the total pension liability and related measures. This Statement clarifies that payments that are made by an employer to satisfy contribution requirements that are identified by the pension plan terms as plan member contribution requirements should be classified as plan member contributions for purposes of GASB Statement No. 67 and as employee contributions for purposes of GASB Statement No. 68. It also requires that an employer's expense and expenditures for those amounts be recognized in the period for which the contribution is assessed and classified in the same manner as the employer classifies similar compensation other than pensions (for example, as salaries and wages or as fringe benefits). The requirements of this Statement are effective for reporting periods beginning after June 15, 2016, except for the requirements of this Statement for the selection of assumptions in a circumstance in which an employer's pension liability is measured as of a date other than the employer's most recent fiscal year-end. In that circumstance, the requirements for the selection of assumptions are effective for that employer in the first reporting period in which the measurement date of the pension liability is on or after June 15, 2017. The System already adopted the requirements of this statement except for the amendments related to the selection of assumptions mentioned above for which the System is evaluating the impact of this new requirement.

- GASB Statement No. 85, *Omnibus 2017*. The objective of this Statement is to address practice issues that have been identified during implementation and application of certain GASB Statements. This Statement addresses a variety of topics including issues related to blending component units, goodwill, fair value measurement and application, and postemployment benefits (pensions and other postemployment benefits (OPEB)). The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2017. The System is evaluating the impact of this new statement.
- GASB Statement No. 87, *Leases*. The objective of this Statement is to better meet the information needs of financial statement users by improving accounting and financial reporting for leases by governments. This Statement increases the usefulness of governments' financial statements by requiring recognition of certain lease assets and liabilities for leases that previously were classified as operating leases and recognized as inflows of resources or outflows of resources based on the payment provisions of the contract. It establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. Under this Statement, a lessee is required to recognize a lease liability and an intangible right-to-use lease asset, and a lessor is required to recognize a lease receivable and a deferred inflow of resources, thereby enhancing the relevance and consistency of information about governments' leasing activities. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2019. The System is evaluating the impact of this new statement.

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- GASB Statement No. 88, *Certain disclosures related to debt, including direct borrowings and direct placements*. The primary objective of this Statement is to improve the information that is disclosed in notes to government financial statements related to debt, including direct borrowings and direct placements. It also clarifies which liabilities governments should include when disclosing information related to debt. This Statement defines debt for purposes of disclosure in notes to financial statements as a liability that arises from a contractual obligation to pay cash (or other assets that may be used in lieu of cash) in one or more payments to settle an amount that is fixed at the date the contractual obligation is established. This Statement requires that additional essential information related to debt be disclosed in notes to financial statements, including unused lines of credit; assets pledged as collateral for the debt; and terms specified in debt agreements related to significant events of default with finance-related consequences, significant termination events with finance-related consequences, and significant subjective acceleration clauses. For notes to financial statements related to debt, this Statement also requires that existing and additional information be provided for direct borrowings and direct placements of debt separately from other debt. The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2018. The System is evaluating the impact of this new statement.

(3) Going Concern Uncertainty

As of June 30, 2017, the System was severely underfunded with a net pension liability of approximately \$32,201 million and a fiduciary net deficit position of approximately \$2,109 million. As a result of fiscal and economic challenges, on May 3, 2017, the Financial Oversight and Management Board for Puerto Rico (the Oversight Board) – at the request of the Governor – commenced a Title III case for the Commonwealth by filing a petition for relief under Title III of the Puerto Rico Oversight Management and Economic Stability Act (PROMESA) in the United States District Court for the District of Puerto Rico (the Title III Court). By commencing a Title III case, the Commonwealth was able to ensure the delivery of essential services to the public and the payment of government payroll and essential suppliers.

On May 21, 2017, the Oversight Board – at the request of the Governor – similarly commenced a Title III case for the System by filing a petition for relief in the Title III Court. On June 15, 2017, the United States Trustee appointed an Official Committee of Retired Employees in the Commonwealth's Title III case.

As further described in note 14 to the basic financial statements, in July 2017, the System sold investments in the total aggregate amount of approximately \$297 million and transferred approximately \$190 million of the net proceeds to the Treasury Department as required under Joint Resolution 188.

Management's Conclusion on Going Concern Consideration

Based on the fiscal and financial difficulties of both the Commonwealth and the System discussed above, management believes there is substantial doubt about the ability of the System to continue as a going concern.

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Management's Remediation Plan

On June 27, 2017, the Treasury Department issued Circular Letter No. 1300-46-17 in order to convey to the Commonwealth central government agencies, public corporations and municipalities the new implementation procedures to adopt, effective, July 1, 2017, a new PayGo system for the payment of pensions. Subsequently, on August 23, 2017, the Governor signed into law Act 106-2017, which established by law the PayGo system for the payment of accumulated pension benefits by the Commonwealth and reformed the System so that its active participants would deposit their individual contributions in a new Defined Contribution Plan, among other significant changes. For additional information on the PayGo system and Act 106-2017, refer to note 14 to the basic financial statements.

Act 106-2017 also suspended the System's loan program and seeks to reduce general and administrative expenses mostly through employee attrition due to normal retirement and reduction in professional services contracts.

(4) Plan Description

Pension Benefits

Before August 23, 2017, the System administered different benefit structures pursuant to Act No. 447, as amended, including a cost-sharing, multi-employer, defined benefit program, a defined contribution program (System 2000 program) and a contributory hybrid program. Benefit provisions vary depending on member's date of hire. Substantially all full-time employees of the Commonwealth and its instrumentalities (73 Commonwealth agencies, 78 municipalities, and 55 public corporations, including the System) are covered by the System. Membership is mandatory for all regular, appointed, and temporary employees of the Commonwealth at the date of employment. Membership is optional for the Governor of the Commonwealth, Commonwealth secretaries, head of public agencies and instrumentalities, among others.

At July 1, 2016, membership of the System consisted of the following:

| | |
|---|-----------------------|
| Retirees and beneficiaries currently receiving benefits | 108,035 |
| Current participating employees – defined benefit | 53,832 |
| Current participating employees – System 2000 and Act No. 3 | 64,825 |
| Disabled members, receiving benefits | <u>14,722</u> |
| Total membership | <u><u>241,414</u></u> |

The benefits provided to members of the System are established by Commonwealth law and may be amended only by the Legislature with the Governor's approval. Act No. 3, in conjunction with other recent funding and design changes, provided for a comprehensive reform of the System. This summary details the provisions under Act No. 3.

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Certain provisions are different for the three groups of members who entered the System prior to July 1, 2013 as described below:

- Members of Act No. 447 are generally those members hired before April 1, 1990. (contributory, defined benefit program)
- Members of Act No. 1 are generally those members hired on or after April 1, 1990 and on or before December 31, 1999. (contributory, defined benefit program)
- Members of Act No. 305 (or System 2000) are generally those members hired on or after January 1, 2000 and on or before June 30, 2013. (defined contribution program)

All regular employees hired for the first time on or after July 1, 2013, and former employees who participated in the defined benefit program and the System 2000 program, and were rehired on or after July 1, 2013, become members of the Contributory Hybrid Program as a condition to their employment. In addition, employees who at June 30, 2013, were participants of previous programs became part of the Contributory Hybrid Program on July 1, 2013.

Each member has a non-forfeitable right to the value of their account. Members have three options to invest their contributions. Investment income is credited to the member's account semi-annually. The Commonwealth does not guarantee benefits at retirement age.

The assets of the defined benefit program, the defined contribution program and the Contributory Hybrid Program were pooled and invested by the System.

This summary of the System's pension plan provisions is intended to describe the essential features of the plan before the enactment of Act 106-2017. All eligibility requirements and benefit amounts shall be determined in strict accordance with the applicable plan documents.

(a) Service Retirements

- (1) *Eligibility for Act No. 447 Members* – Act No. 447 members who were eligible to retire as of June 30, 2013 continue to be eligible to retire at any time. Prior to July 1, 2013, Act No. 447 members could retire upon (1) attainment of age 55 with 25 years of credited service, (2) attainment of age 58 with 10 years of credited service, (3) any age with 30 years of credited service, (4) for Public Officers in High Risk Positions (the Commonwealth Police and Firefighter Corps, the Municipal Police and Firefighter Corps and the Custody Office Corps), attainment of age 50 with 25 years of credited service, and (5), for Mayors of municipalities, attainment of age 50 with 8 years of credited service as a Mayor. In addition, Act No. 447 members who attained 30 years of credited service by December 31, 2013 are eligible to retire at any time.

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Act No. 447 members who were not eligible to retire as of June 30, 2013 and did not attain 30 years of credited service by December 31, 2013 are eligible to retire upon attainment of the retirement eligibility age shown in the table below with 10 years of credited service.

| <u>Date of birth</u> | <u>Attained age as of June 30, 2013</u> | <u>Retirement eligibility age</u> |
|-------------------------------|---|---------------------------------------|
| July 1, 1957 or later | 55 or less | 61 |
| July 1, 1956 to June 30, 1957 | 56 | 60 |
| Before July 1, 1956 | 57 and up | 59 |

In addition to the requirements in the table above, Act No. 447 provides that Public Officers in High Risk Positions who were not eligible to retire as of June 30, 2013 and did not attain 30 years of credited service by December 31, 2013 are eligible to retire directly from active service upon the attainment of age 55 with 30 years of credited service.

- (2) *Eligibility for Act No. 1 Members* – Act No. 1 members who were eligible to retire as of June 30, 2013 continue to be eligible to retire at any time. Prior to July 1, 2013, Act No. 1 members could retire upon (1) attainment of age 55 with 25 years of credited service, (2) attainment of age 65 with 10 years of credited service, (3) for Public Officers in High Risk Positions, any age with 30 years of credited service, and (4) for Mayors, attainment of age 50 with 8 years of credited service as a Mayor.

Act No. 1 members who were not eligible to retire as of June 30, 2013 are eligible to retire upon attainment of age 65 with 10 years of credited service. In addition, Act No. 1 Public Officers in High Risk Positions who were not eligible to retire as of June 30, 2013 are eligible to retire directly from active service upon the attainment of age 55 with 30 years of credited service.

- (3) *Eligibility for System 2000 Members* – System 2000 members who were eligible to retire as of June 30, 2013 continue to be eligible to retire at any time. Prior to July 1, 2013, System 2000 members could retire upon attainment of age 55 for Public Officers in High Risk Positions and attainment of age 60 otherwise.

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System 2000 members who were not eligible to retire as of June 30, 2013 are eligible to retire upon attainment of age 55 for Public Officers in High Risk Positions and upon attainment of the retirement eligibility age shown in the table below otherwise.

| <u>Date of birth</u> | <u>Attained age as of June 30, 2013</u> | <u>Retirement eligibility age</u> |
|-------------------------------|---|---------------------------------------|
| July 1, 1957 or later | 55 or less | 65 |
| July 1, 1956 to June 30, 1957 | 56 | 64 |
| July 1, 1955 to June 30, 1956 | 57 | 63 |
| July 1, 1954 to June 30, 1955 | 58 | 62 |
| Before July 1, 1954 | 59 and up | 61 |

(4) *Eligibility for Members Hired after June 30, 2013* – Attainment of age 58 if a Public Officer in a High Risk Position and attainment of age 67 otherwise.

(b) Service Retirement Annuity Benefits

An annuity is payable for the lifetime of the member equal to the annuitized value of the balance in the Defined Contribution Hybrid Contribution Account at the time of retirement, plus, for Act No. 447 and Act No. 1 members, the accrued benefit determined as of June 30, 2013. If the balance in the Defined Contribution Hybrid Contribution Account is \$10,000 or less, it shall be paid as a lump sum instead of as an annuity. For System 2000 participants this service retirement annuity benefit is not available.

(1) *Accrued Benefit as of June 30, 2013 for Act No. 447 Members* – The accrued benefit as of June 30, 2013 shall be determined based on the average compensation, as defined, for Act No. 447 members, the years of credited service, and the attained age of the member all as of June 30, 2013. For Act No. 447 Mayors, the highest compensation, as defined, as a Mayor is determined as of June 30, 2013.

If the Act No. 447 member had at least 30 years of credited service as of June 30, 2013, the accrued benefit equals 65% of average compensation if the member was under age 55 as of June 30, 2013 or 75% of average compensation if the member was at least age 55 as of June 30, 2013. For participants selecting to coordinate with social security (the Coordination Plan), the benefit is re-calculated at the Social Security Retirement Age (SSRA), as defined, as 1.5% of average compensation up to \$6,600 multiplied by years of credited service, up to 30 years, plus 65% (75% if member was at least age 55 as of June 30, 2013) of average compensation in excess of \$6,600.

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If the Act No. 447 member had less than 30 years of credited service as of June 30, 2013, and attains 30 years of credited service by December 31, 2013, the accrued benefit equals 55% of average compensation if the member was under age 55 as of June 30, 2013 or 60% of average compensation if the member was at least age 55 as of June 30, 2013. For participants selecting the Coordination Plan, the benefit is re-calculated at SSRA as 1.5% of average compensation up to \$6,600 multiplied by years of credited service, up to 30 years, plus 55% (60% if member was at least age 55 as of June 30, 2013) of average compensation in excess of \$6,600. Member contributions received from Act No. 447 members eligible for this transitory benefit during the period beginning July 1, 2013 and ending upon the attainment of 30 years of credited service are considered pre-July 1, 2013 contributions; the contributions to the Defined Contribution Hybrid Contribution Account begin after the member attains 30 years of credited service.

If the Act No. 447 member had less than 30 years of credited service as of December 31, 2013, the accrued benefit equals 1.5% of average compensation multiplied by years of credited service up to 20 years, plus 2% of average compensation multiplied by years of credited service in excess of 20 years. Maximum benefit is 75% of average compensation. Except for Commonwealth Police and Commonwealth Firefighters, the benefit is actuarially reduced for each year payment commences prior to age 58. For participants selecting the Coordination Plan, the basic benefit is re-calculated at SSRA as 1% of average compensation up to \$6,600 multiplied by years of credited service up to 20 years, plus 1.5% of average compensation up to \$6,600 multiplied by years of credited service in excess of 20 years, plus 1.5% of average compensation in excess of \$6,600 multiplied by years of credited service up to 20 years, plus 2.0% of average compensation in excess of \$6,600 multiplied by years of credited service in excess of 20 years. Except for Police and Firefighters, the benefit is actuarially reduced for each year payment commences prior to age 58.

For Act No. 447 Mayors with at least 8 years of credited service as a mayor, the accrued benefit will not be less than 5% of highest compensation, as defined, as a Mayor for each year of credited service as a Mayor up to 10 years, plus 1.5% of highest compensation as Mayor for each year of non-Mayoral credited service up to 20 years, plus 2.0% of highest compensation as Mayor for each year of non-Mayoral credited service in excess of 20 years. Non-Mayoral credited service includes service earned as a Mayor in excess of 10 years. Maximum benefit is 90% of highest compensation as a Mayor.

- (2) *Accrued Benefit as of June 30, 2013 for Act No. 1 Members* – The accrued benefit as of June 30, 2013 shall be determined based on the average compensation for Act No. 1 members, the years of credited service, and the attained age of the member all as of June 30, 2013. For Act No. 1 Mayors, the highest compensation as a Mayor is determined as of June 30, 2013.

If the Act No. 1 member is a police officer or firefighter with at least 30 years of credited service as of June 30, 2013, the accrued benefit equals 65% of average compensation if the member was under age 55 as of June 30, 2013 or 75% of average compensation if the member was at least age 55 as of June 30, 2013.

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For all other Act No. 1 members, the accrued benefit equals 1.5% of average compensation multiplied by years of credited service. The benefit is actuarially reduced for each year payment commences prior to age 65.

For Act No. 1 Mayors with at least 8 years of credited service as a mayor, the accrued benefit will not be less than 5% of highest compensation as a Mayor for each year of credited service as a Mayor up to 10 years, plus 1.5% of highest compensation as Mayor for each year of non-Mayoral credited service up to 20 years, plus 2.0% of highest compensation as Mayor for each year of non-Mayoral credited service in excess of 20 years. Non-Mayoral credited service includes service earned as a Mayor in excess of 10 years. Maximum benefit is 90% of highest compensation as a Mayor.

(c) Compulsory Retirement

All Act No. 447 and Act No. 1 Public Officers in High Risk Positions must retire upon attainment of age 58 and 30 years of credited service. A two year extension may be requested by the member from the Superintendent of the Puerto Rico Police, the Chief of the Firefighter Corps, or supervising authority as applicable.

(d) Termination Benefits

(1) Lump Sum Withdrawal

Eligibility: A Member is eligible upon termination of service prior to 5 years of service or if the balance in the Defined Contribution Hybrid Contribution Account is \$10,000 or less.

Benefit: The benefit equals a lump sum payment of the balance in the Defined Contribution Hybrid Contribution Account as of the date of the permanent separation of service.

(2) Deferred Retirement

Eligibility: A Member is eligible upon termination of service with 5 or more years of service (10 years of credited service for Act No. 447 and Act No. 1 members) prior to the applicable retirement eligibility, provided the member has not taken a lump sum withdrawal of the accumulated contributions and the Defined Contribution Hybrid Contribution Account.

Benefit: An annuity payable for the lifetime of the member commencing at the applicable retirement eligibility age is equal to the annuitized value of the balance in the Defined Contribution Hybrid Contribution Account at the time of retirement, plus, for Act No. 447 and Act No. 1 members, the accrued benefit determined as of June 30, 2013.

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(e) Death Benefits

(1) Pre-Retirement Death Benefit

Eligibility: Any current nonretired member is eligible.

Benefit: A refund of the Defined Contribution Hybrid Contribution Account, plus the accumulated contributions for Act No. 447 and Act No. 1 members.

(2) High-Risk Death Benefit under Act No. 127 of 1958, as amended (Act No. 127)

Eligibility: Police, firefighters, and other employees in specified high-risk positions who die in the line of work due to reasons specified in Act No. 127.

Spouse's Benefit: 50% of the participant's compensation at date of death, payable as an annuity until death or remarriage.

Children's Benefit: 50% of the participant's compensation at date of death, payable as an annuity, and allocated pro-rata among eligible children. The annuity is payable for life for a disabled child, until age 18 for a nondisabled child not pursuing studies, and until age 25 for a nondisabled child who is pursuing studies.

Benefit if No Spouse or Children: The parents of the member shall each receive 50% of the participant's compensation at date of death, payable as an annuity for life.

Post-death Increases: Effective July 1, 1996 and subsequently every three years, the above death benefits are increased by 3% provided that the beneficiary(ies) had been receiving payments for at least three years.

The cost of these benefits is paid by the Commonwealth's General Fund.

(3) Post-Retirement Death Benefit for Members who Retired prior to July 1, 2013

Eligibility: Any retiree or disabled member receiving a monthly benefit who has not elected a reversionary annuity and whose benefits commenced prior to July 1, 2013.

Benefit: The benefit is as follows (Law No. 105 of 1969, as amended by Law No. 158 of 2003 and Article 2-113 of Act 447 of 1951 as amended by Act 524 of 2004):

- (i) For those married or with dependent children at the time of death, the annual income to a widow, or widower or dependent children is equal to 60% (50% if in the Coordination Plan – 30% prior to January 1, 2004) of the retirement benefit payable for life for a surviving spouse and/or disabled children and payable until age 18 (age 25 if pursuing studies) for nondisabled children. If in the Coordination Plan, the benefit to the surviving spouse does not begin until the spouse's attainment of age 60 and the surviving spouse must have been married to the member for at least 10 years to be eligible for this benefit. The increase in the percentage from

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30% to 50% if the Coordination Plan is paid by the Commonwealth's General Fund for former government employees or by a public corporation or municipality for their former employees. As stated in Law 105 of 1969 as amended by Act 158 of 2003.

- (ii) The benefit, when there is no relation as stated above, is equal to the remaining balance of accumulated contributions at the time of retirement after the deduction of lifetime annual income paid and is payable to a beneficiary or to the member's estate. In no case shall the benefit be less than \$1,000. Either the Commonwealth's General Fund for former government employees or the public enterprise or municipality for their former employees pays the difference, up to \$250, between (1) the accumulated contributions less the lifetime annual income paid and (2) \$1,000. The System pays for the rest. As stated in Article 2-113 of Act 447 of 1951 as amended by Act 524 of 2004.

(4) Post-Retirement Death Benefit for Members who Retired after June 30, 2013

Eligibility: Any retiree or disabled member who began receiving a monthly benefit after June 30, 2013.

Benefit: If the member elected at the time of retirement to transfer a portion of the annuity to a beneficiary by selecting an actuarially equivalent optional form of payment, the benefit is the applicable survivor benefit selected.

For all members, the excess, if any, of the Defined Contribution Hybrid Contribution Account, plus the accumulated contributions for Act No. 447 and Act No. 1 members, at the time of retirement over the total annuity payments paid to the member and any beneficiary per the terms of the optional form of payment shall be payable to a beneficiary or the member's estate.

- (5) Beneficiaries receiving occupational death benefits as of June 30, 2013 continue to be eligible to receive such benefits.

(f) Disability Benefits

(1) Disability

Eligibility: All members are eligible upon the occurrence of disability.

Benefit: The balance of the Defined Contribution Hybrid Contribution Account payable as lump sum distribution, an immediate annuity or a deferred annuity at the election of the participant. Act No. 447 and Act No. 1 members remain eligible to receive the accrued benefit as of June 30, 2013 commencing at the applicable retirement eligibility age.

(2) High Risk Disability under Act No. 127

Eligibility: Police, firefighters, and other employees in specified high-risk positions who are disabled in the line of work due to reasons specified in Act No. 127 of 1958 (as amended).

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Benefit: 80% (100% for Act No. 447 members) of compensation as of date of disability, payable as an annuity. If the member dies while still disabled, this annuity benefit continues to his beneficiaries. Beneficiaries include the surviving spouse and/or disabled children (for life), nondisabled children until age 18 (age 25 if pursuing studies), and the parents if no other beneficiaries. Effective July 1, 1996 and subsequently every three years, the disability benefit is increased by 3% provided that the member (or beneficiary) had been receiving payments for at least three years (Act No. 127 of 1958, as amended). The cost of these benefits is paid by the Commonwealth's General Fund.

- (3) Members who qualified for occupational or nonoccupational disability benefits as of June 30, 2013 continue to be eligible to receive such benefits.

(g) Special Benefits

(1) Minimum Benefits

(i) Past Ad hoc Increases

The Legislature, from time to time, increases pensions for certain retirees as described in Act No. 124 approved on June 8, 1973 and Act No. 23 approved on September 23, 1983. The benefits are paid 50% by the Commonwealth's General Fund and 50% by the System.

(ii) Minimum Benefit for Members who Retired before July 1, 2013 (Act No. 156 of 2003, Act No. 35 of 2007, and Act No. 3 of 2013)

The minimum monthly lifetime income for members who retired or become disabled before July 1, 2013 is \$500 per month effective July 1, 2013 (\$400 per month effective July 1, 2007 and \$300 per month up to June 30, 2007). The increase in the minimum monthly benefit from \$200 per month to \$300 per month is paid by the Commonwealth's General Fund for former government and certain public corporations without their own treasuries employees or by certain public corporations with their own treasuries or municipalities for their former employees. The increase in the minimum monthly benefit from \$300 per month to \$400 per month is to be paid by the System for former government and certain public corporations without their own treasuries employees or by certain public corporations with their own treasuries or municipalities for their former employees.

(iii) Coordination Plan Minimum Benefit

A minimum monthly benefit is payable upon attainment of SSRA such that the benefit, when added to the Social Security Benefit, is not less than the benefit payable prior to SSRA.

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(2) Cost-of-Living Adjustments (COLA) to Pension Benefits

The Legislature, from time to time, increased pensions by 3% for retired and disabled members. Beneficiaries are not entitled to COLAs granted after the retiree's death. The first increase was granted by Act No. 10 of 1992. Subsequent 3% increases have been granted every third year since 1992, with the latest 3% increase established on April 24, 2007 and effective July 1, 2007 (retroactive to January 1, 2007) for retired and disabled members that were receiving a monthly benefit on or before January 1, 2004 (Act 35 of 2007). In addition, effective July 1, 2008, any retired or disabled member that was receiving a monthly annuity on or before January 1, 2004 less than \$1,250 per month received an increase of up to 3% without exceeding the limit of \$1,250 per month (Act 35 of 2007). The COLAs granted in 1992 to all retirees and in 1998 to retirees who are former government or municipal employees shall be paid by the System. All other COLAs granted in 1995 and later shall be paid by the Commonwealth's General Fund for former government and certain public corporations without their own treasuries employees or by certain public corporations with their own treasuries or municipalities for their former employees.

(3) Special "Bonus" Benefits

(i) Christmas Bonus (Act No. 144, as Amended by Act No. 3)

An annual bonus of \$200 for each retiree, beneficiary, and disabled member paid in December provided the member retired prior to July 1, 2013. This benefit is paid from the supplemental contributions received from the Commonwealth's General Fund for former government and certain public corporations without their own treasuries employees or by certain public corporations with their own treasuries or municipalities for their former employees.

(ii) Medication Bonus (Act No. 155, as Amended by Act No. 3)

An annual bonus of \$100 for each retiree, beneficiary, and disabled member to cover health costs paid in July provided the member retired prior to July 1, 2013. Evidence of coverage is not required. The amount is prorated if there are multiple beneficiaries. This benefit is paid from the supplemental contributions received from the Commonwealth's General Fund for former government and certain public corporations without their own treasuries' employees or by certain public corporations with their own treasuries or municipalities for their former employees.

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(h) Contributions

- (1) *Member Contributions (Article 5-105 of Law 447, as amended by Law No. 3 of 2013, amended by Law No. 106 of 2017 and amended by Law 71 of 2019)*

Effective July 1, 2013 through June 30, 2017, contributions by members consisted of 10% of compensation. However, for Act No. 447 members who selected the Coordination Plan, the member contributions were 7% of compensation up to \$6,600 plus 10% of compensation in excess of \$6,600 during the 2013-2014 fiscal year and 8.5% of compensation up to \$6,600 plus 10% of compensation in excess of \$6,600 during the 2014-2015 fiscal year. Effective July 1, 2015 members who selected the Coordination Plan, member contribution increased to 10% of compensation. Members may voluntarily make additional contributions to their Defined Contribution Hybrid Contribution Account.

Prior to July 1, 2013, contributions by Act No. 447 members selecting the Coordination Plan were 5.775% of compensation up to \$6,600 plus 8.275% of compensation in excess of \$6,600. Contributions by all other members were 8.275% of compensation. System 2000 members may also have made voluntary contributions of up to 1.725% of compensation prior to July 1, 2013.

Effective July 1, 2017, contributions by members consists of 8.5% of compensation. However, in the case of members of the rank system of the Puerto Rico Police Bureau, the mandatory contribution is 2.3% of their compensation. In the case of those members of the rank system of the Puerto Rico Police Bureau which have less than 10 years to qualify for retirement as established by Act No. 447, the reduction in the percentage of contribution will apply voluntarily.

- (2) *Employer Contributions (Article 2-116 of Law 447, as Amended by Law No. 116 of 2011 and Act No. 3 of 2013, eliminated effective on July 1, 2017 by Act 106 of 2017)*

Prior to July 1, 2011, employer contributions were 9.275% of compensation. Effective July 1, 2011, employer contributions were 10.275% of compensation. For the next four fiscal years effective July 1, employer contributions were scheduled to increase annually by 1% of compensation. For the five fiscal years thereafter, employer contributions will increase annually by 1.25% of compensation. Act 106 of 2017 eliminated the employer contributions to the System as of July 1, 2017.

- (3) *Supplemental Contributions from the Commonwealth's General Fund, Certain Public Corporations, and Municipalities (Act No. 3 of 2013, eliminated on July 1, 2017 by Act 106 of 2017)*

Effective July 1, 2013, the System will receive a supplemental contribution of \$2,000 each fiscal year for each pensioner (including beneficiaries receiving survivor benefits) who was previously benefitting as an Act No. 447 or Act No. 1 member while an active employee. This supplemental contribution will be paid by the Commonwealth's General Fund for former government and certain public corporations without their own treasuries employees or by certain public corporations with their own treasuries or municipalities for their former employees.

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The special benefits contribution requirement to the System is established by law and is not actuarially determined. The special benefits contributions of approximately \$195 million in 2017 mainly represent contributions from the Commonwealth's General Fund, public corporations and municipalities for the special benefits identified above granted by special laws. The funding of the special benefits is provided to the System through legislative appropriations each July 1 by the Commonwealth's General Fund for former government and certain public corporations without their own treasuries employees, and by certain public corporations with their own treasuries and municipalities for their former employees. The legislative appropriations are considered estimates of the payments to be made by the System for the special benefits. Deficiencies in legislative appropriations are covered by the System's own funds until recovered through future legislative appropriations. Any surplus of legislative appropriations collected over special benefits paid is combined with the assets held in trust for the payment of other pension benefits. During fiscal year June 30, 2017, the System transferred to the Commonwealth's General Fund the amount of \$56.7 million on a monthly basis to cover any deficiency in the payment of special benefits and pensions.

(4) Additional Uniform Contribution (Act No. 32, as Amended)

The Additional Uniform Contribution will be certified by the external actuary of the System each fiscal year from 2015-2016 as necessary to avoid having the projected gross assets of the System, during any subsequent fiscal year, to fall below \$1 billion. The Additional Uniform Contribution is to be paid by the Commonwealth's General Fund, public corporations with their own treasuries, and municipalities. Total Additional Uniform Contribution determined for fiscal year ended June 30, 2017 was \$776 million. As further described in note 14(b), the Additional Uniform Contribution was eliminated by Act 106-2017.

(i) Early Retirement Programs

The Puerto Rico Environmental Quality Board (EQB) implemented an early retirement program for its employees under the Law 244, dated August 9, 2008. EQB has already made the initial payment and would reimburse the remaining balance on annuities and other benefits paid by the System in four installments on each July 31 starting in 2009 through 2012. The EQB was at default on the retirement plan payment, so they requested a new payment plan. The System's Board of Trustees approved a payment plan for the debt balance due of the retirement program for 24 months starting in March 2014.

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On July 2, 2010, the Commonwealth enacted Act No. 70 establishing a program that provides benefits for early retirement or economic incentives for voluntary employment termination to eligible employees, as defined. Act No. 70 of 2010 (Act No. 70) also established that early retirement benefits will be provided to eligible employees that have completed between 15 to 29 years of creditable services and will consist of monthly benefits ranging from 37.5% to 50% of each employees' monthly salary. Benefits under this program will be paid by the Commonwealth's the General Fund and by the public corporations, covering their respective employees until the plan member reaches the later of age 55 for members under Act No. 447 or age 65 for members under Act No. 1, or the date the plan member would have completed 30 years of service had the member continued employment. In addition, the public corporations will also be required to continue making the required employee and employer contributions to the System. The Commonwealth's General Fund will be required to continue making its required employer contributions. The System will be responsible for benefit payments afterwards. As of June 30, 2017, the System recorded a liability of approximately \$15 million for its responsibility as an employer under Act No. 70.

On December 8, 2015, the Commonwealth enacted the Voluntary Early Retirement Law, Act No. 211 of 2015 (Act No. 211), establishing a voluntary program to provide pre-retirement benefits to eligible employees, as defined. Act No. 211 applies to eligible employees of agencies and component units whose budgets are funded in whole or in part by the Commonwealth's General Fund, municipalities, component units that operate with their own resources (except those that have their own retirement system), Judiciary Branch, except judges, and the Commonwealth Employees Association. Act No. 211, among other provisions, established that pre-retirement benefits would be provided to eligible employees who started contributing to the System before April 1, 1990 with at least 20 years of service and would consist of biweekly benefits of 60% of the of each employee's salary as of December 31, 2015, as defined. Pursuant to Act No. 211, the employers will continue making the applicable employee and employer contributions to the Retirement Systems and the employer Social Security and Medicare contributions based on average employee salary, as defined, as of December 31, 2015. Individual Social Security and Medicare contribution would be deducted from the biweekly benefits to be paid to the participant. These payments would be made until the employee reaches the age of 61 years. Other benefits would include the payment of the participant's healthcare plan during the first two years of the program. Once the participant reaches 61 years of age, the participant would be eligible to receive payments from the System and would be entitled to a guaranteed minimum pension of 50% of their average salary (except police officers, which would be paid 60%), and related costs would be paid by the employer.

As described in note 14, Act 106-2017 repealed Act No. 211, while creating an incentives, opportunities and retraining program for public workers.

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(j) Other Postemployment Benefits (OPEB) – Healthcare Benefits

ERS MIPC is an unfunded cost-sharing, multi-employer defined benefit other postemployment benefit plan sponsored by the Commonwealth. ERS MIPC covers a payment of up to \$100 per month to the eligible medical insurance plan selected by the member provided the member retired prior to July 1, 2013 (Act No. 483, as amended by Act No. 3). Substantially all full time employees of the Commonwealth’s central government, certain municipalities of Puerto Rico and certain component units of the Commonwealth not having their own postemployment benefit plan, were covered by the OPEB.

Commonwealth employees became members upon their date of employment. Plan members were eligible for benefits upon reaching the pension benefits retirement ages.

At July 1, 2016, the membership consisted of the following:

| | |
|------------------|-----------------------|
| Membership: | |
| Retired members | 94,071 |
| Disabled members | <u>14,722</u> |
| Total membership | <u><u>108,793</u></u> |

The contribution requirement of ERS MIPC is established by Act No. 95 approved on June 29, 1963. This OPEB plan is financed by the Commonwealth. There is no contribution requirement from the plan member during active employment. Retirees contribute the amount of the healthcare insurance premium not covered by the Commonwealth contribution. As a result, these OPEB are 100% unfunded. During the year ended June 30, 2017, OPEB contributions amounted to \$91 million.

The funding of the OPEB benefits is provided to the System through legislative appropriations each July 1 by the Commonwealth’s General Fund for former government and certain public corporations without their own treasuries employees, and by certain public corporations with their own treasuries and municipalities for their former employees. The legislative appropriations are considered estimates of the payments to be made by the System for the healthcare benefits throughout the year.

(5) Net Pension Liability

The components of the net pension liability as of June 30, 2017 were as follows (dollars in thousands):

| | |
|--|-----------------------------|
| Total pension liability | \$ 30,091,826 |
| Plan’s fiduciary net deficit | <u>(2,108,853)</u> |
| Net pension liability | <u><u>\$ 32,200,679</u></u> |
| Plan’s fiduciary net deficit as a percentage of the total pension liability | (7.01)% |

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(a) Actuarial Methods and Assumptions

The census data collection date is at the beginning-of-the fiscal year. The liability results as of June 30, 2017 are based on projecting the System obligations determined as of the census data collection date of July 1, 2016 for one year, using roll-forward methods and assuming no liability gains or losses.

The actuarial valuation used the following actuarial assumptions:

| | |
|----------------------------|--|
| Inflation | Not applicable |
| Municipal bond index | 3.58%%, as per Bond Buyer General Obligation 20-Bond Municipal Bond Index |
| Projected salary increases | 3.00% per year. No compensation increases are assumed until July 1, 2021 as a result of Act No. 3-2017 and the current general economy. |
| Mortality | <p>Pre-retirement Mortality:</p> <p>For general employees not covered under Act No. 127, RP-2014 Employee Mortality Rates for males and females adjusted to reflect Mortality Improvement Scale MP-2017 from the 2006 base year, and projected forward using MP-2017 on generational basis. For members covered under Act No. 127, RP-2014 Employee Mortality Rates with blue collar adjustments for males and females adjusted to reflect Mortality Improvement Scale MP-2017 from the 2006 base year, and projected forward using MP-2017 on generational basis. As generational tables, they reflect mortality improvements both before and after the measurement date.</p> <p>100% of deaths while in active service are assumed to be occupational for members covered under Act No. 127.</p> |

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Post-retirement Healthy Mortality:

Rates which vary by gender are assumed for healthy retirees and beneficiaries based on a study of plan's experience from 2007 to 2012 and updated expectations regarding future mortality improvement. The 2010 base rates are equal to 92% of the rates from the UP-1994 Mortality Table for Males and 95% of the rates from the UP-1994 Mortality Table for Females, both projected from 1994 to 2010 using Scale AA. The base rates are projected using Mortality Improvement Scale MP-2017 on a generational basis. As a generational table, it reflects mortality improvements both before and after the measurement date.

Post-retirement Disabled Mortality:

Rates which vary by gender are assumed for disabled retirees based on a study of plan's experience from 2007 to 2012 and updated expectations regarding future mortality improvement. The 2010 base rates are equal to 105% of the rates from the UP-1994 Mortality Table for Males and 115% of the rates from the UP-1994 Mortality Table for Females. The base rates are projected using Mortality Improvement Scale MP-2017 on a generational basis. As a generational table, it reflects mortality improvements both before and after the measurement date.

Most other demographic assumptions used in the June 30, 2017 valuation were based on the results of an actuarial experience 2009 study using data as of June 30, 2003, June 30, 2005 and June 30, 2007.

(b) Long-Term Expected Rate of Return

The long-term expected rate of return on pension benefits investments was not applicable as of June 30, 2017. Net assets are negative as of June 30, 2017 and accordingly, it is not possible to determine a rate of return on net assets during the fiscal year. In addition, after June 30, 2017, due to the PayGo system by which the Commonwealth guarantees payment of pensions. System assets were no longer necessary to generate investment returns to pay pension benefits. The approximate actual rate of return on gross assets was 8.74% as of June 30, 2017.

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Before June 30, 2017, the pension plan's policy for allocation of invested assets has been established and may be amended by the System's Board of Trustees. Plan assets are managed on a total return basis with a long-term objective of achieving and maintaining a positive impact on the System's financial condition for the benefits provided through the pension programs. The following asset allocation policy as of June 30, 2017 was adopted by the System's Board of Trustees:

| | <u>Target allocation</u> | <u>Long-term expected rate of return</u> |
|----------------------|------------------------------|--|
| Asset class: | | |
| Domestic equity | 56 % | N/A |
| International equity | 15 | N/A |
| Fixed income | 28 | N/A |
| Cash | <u>1</u> | N/A |
| Total | <u>100 %</u> | |

In prior years, the long-term expected rate of return on pension benefits investments was determined using a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. This year, the long-term expected rate of return assumption is no longer applicable.

(c) Discount Rate

The asset basis for the date of depletion projection is the System's fiduciary net position (the gross assets plus deferred outflows of resources less the gross liabilities, including the senior pension funding bonds payable, plus deferred inflows of resources). On this basis, the System's fiduciary net position was exhausted in the fiscal year 2015.

The System's fiduciary net position was not projected to be available to make all projected future benefit payments of current active and inactive employees. Therefore, the tax free municipal bond index (Bond Buyer General Obligation 20-Bond Municipal Bond Index) was applied to all periods of projected benefits payments to determine the total pension liability. The discount rate was 3.58% as of June 30, 2017.

The June 30, 2017, actuarial valuation reflects a decrease of \$5,498 million in the net pension liability, mainly related to changes in assumptions of \$4,179 million, as a result of an increase in the discount rate as required by GASB Statement No. 67 from 2.85% in fiscal year 2016 to 3.58% in fiscal year 2017, and the effect of plan changes of approximately \$2,017 million.

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(d) Sensitivity of the Net Pension Liability to Changes in the Discount Rate

The following presents the net pension liability calculated using the discount rate of 3.58%, as well as what it would be if it were calculated using a discount rate of 1%-point lower (2.58%) or 1% point higher (4.58%) than the current rate (dollars in thousands):

| | 1% Decrease (2.58%) | Current discount rate (3.58%) | 1% Increase (4.58%) |
|-----------------------|--------------------------------|--|--------------------------------|
| Net pension liability | \$ 36,599,444 | 32,200,679 | 28,666,953 |

(6) Cash and Cash Equivalents, Investments and Securities Lending Transactions

Cash and Cash Equivalents

Cash and cash equivalents as of June 30, 2017 consisted of the following (in thousands):

| | Carrying amount | Depository bank balance | Amount uninsured and uncollateralized |
|--|----------------------------|--|--|
| Deposits with GDB | \$ — | 30,027 | 30,027 |
| Deposits with Puerto Rico commercial banks | 460,174 | 454,587 | — |
| Money market funds | 15,619 | N/A | N/A |
| U.S. Treasury bills | 909 | N/A | N/A |
| Total | \$ 476,702 | 484,614 | 30,027 |

Custodial credit risk for deposits is the risk that, in an event of the failure of a depository financial institution, the System may not be able to recover deposits or collateral securities that are in the possession of an outside party. The Commonwealth requires that public funds deposited in Puerto Rico commercial banks be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by banks in the Commonwealth's name. Deposits with GDB and with non-Puerto Rico commercial banks and money market funds are uninsured and uncollateralized, as these entities are exempt from compliance with the collateralization requirement.

Restricted cash and cash equivalent amounted to approximately \$216 million as of June 30, 2017 and consisted of the following:

- Approximately \$1.9 million of funds are restricted for the debt service of the bonds payable, and 100% of such funds were deposited at trustee in money market funds

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- Approximately \$214 million of funds are restricted for repayments of mortgage and personal loans administrated by the mortgage servicers and the System, for expired checks not claimed by the plan members, and other purposes, of which approximately \$11 million of funds were deposited at trustee in money market accounts, approximately \$126,000 of funds were deposited at GDB and approximately \$202 million were deposited at Puerto Rico commercial banks.

Custodial Credit Loss on Deposits with GDB

Management determined based on the information available prior to the issuance of the System’s financial statements for the fiscal year ended June 30, 2017 that a custodial credit loss existed as of June 30, 2017 for the deposits held at GDB.

GDB continues to face a critical economic situation as of June 30, 2017 and currently does not have sufficient liquid financial resources to meet obligations when they come due. The Commonwealth and its public entities have not been able to repay their loans from GDB, which has significantly affected GDB’s liquidity and ability to repay its obligations. Because of the nonpayment by the Commonwealth of the appropriation to GDB and GDB’s inability to restructure its debt considering the broader fiscal crisis faced by the Commonwealth, GDB is in default of its debt obligations since May 1, 2016.

Pursuant to enacted legislation in April 2016, the Governor of the Commonwealth imposed on GDB emergency operational restrictions and debt moratorium. These restrictions included the suspension of loan disbursements from GDB, imposed restrictions on the withdrawal and transfer of deposits from GDB, and imposed a moratorium on debt obligation of GDB, among other measures.

On April 28, 2017, the Oversight Board approved the liquidation proposal included in the GDB’s fiscal plan that calls for an orderly winding down its operations over ten years.

On March 23, 2018, GDB ceased its operations and determined to wind down in an orderly fashion under Title VI of PROMESA.

Based on an evaluation of the availability and recoverability of such funds, a custodial credit loss on these deposits has been recorded on the System’s financial statements as follows (expressed in thousands):

| | Deposits held with GDB at June 30, 2017 | | |
|---------------------------|--|--------------------------------------|---------------------------|
| | Carrying value before impairment loss | Custodial credit loss | Carrying value |
| Type of deposit: | | | |
| Interest bearing accounts | \$ 30,027 | 30,027 | — |
| Total | \$ 30,027 | 30,027 | — |

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The realizable balance of the deposits held with the GDB as of June 30, 2017 was determined based on the corresponding actual collections received from the GDB on such deposits after the June 30, 2017 year end.

Investments

For the year ended June 30, 2017, the annual money-weighted rate of return on investments, net of investment expenses, was 8.74%. The money-weighted rate of return expresses investment performance, net of investment expense, adjusted for the changing amounts actually invested.

Fair Value Measurement

The System categorizes its fair value measurements within the fair value hierarchy established by GAAP. The hierarchy is based on the inputs used in valuation and gives the highest priority to unadjusted quoted prices in active markets and requires that observable inputs be used in the valuations when available. The disclosure of fair value estimates in the hierarchy is based on whether the significant inputs into the valuations are observable. In determining the level of the hierarchy in which the estimate is disclosed, the highest level, Level 1, is given to unadjusted quoted prices in active markets and the lowest level, Level 3, to unobservable inputs.

Level 1 – Inputs whose values are based on unadjusted quoted prices for identical instruments in active markets that the System has the ability to access.

Level 2 – Inputs whose values are based on quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs are observable.

Level 3 - Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

In instances where inputs used to measure fair value fall into different levels in the fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The System's assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each investment. Investments measured at Net Asset Value (NAV) as practical expedient are not subject to level classification.

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The table below shows the fair value leveling of the System's investments:

| Investment type | Level 1 | Level 2 | Level 3 | Total |
|---|-----------|---------|---------|---------|
| Investments measured at fair value: | | | | |
| U.S. government securities | \$ 8,884 | — | — | 8,884 |
| U.S. government sponsored agencies obligations | 9,789 | — | — | 9,789 |
| Mortgage and asset-backed securities | 6,540 | — | — | 6,540 |
| U.S. corporate bonds and notes | — | 64,939 | — | 64,939 |
| Non U.S. corporate bonds | — | 14,811 | — | 14,811 |
| COFINA bonds | — | 58,224 | — | 58,224 |
| Investments at fair value level | \$ 25,213 | 137,974 | — | 163,187 |
| Investments measured at NAV as a practical expedient: | | | | |
| Non exchange commingled trust funds: | | | | |
| U.S. Equity trust funds | | | | 120,498 |
| Non U.S. Equity trust funds | | | | 61,201 |
| Investments in limited partnerships | | | | 87,069 |
| Total Investments | | | \$ | 431,955 |

The System's investments are exposed to custodial credit risk, credit risk, concentration of credit risk, foreign currency risk, and interest rate risk. Following is a description of these risks as of June 30, 2017:

(a) Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the System may not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. At June 30, 2017, securities investments were registered in the name of the System and were held in the possession of the System's custodian banks, except for securities lent. Securities lent are not exposed to custodial credit risk. Cash collateral received from securities lending transactions invested in short-term investments is exposed to custodial credit risk.

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(b) Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. All fixed-income securities at the time of purchase must be of investment grade quality. All issuances shall be rated investment grade by at least two of the nationally recognized rating agencies. The portfolio is expected to maintain a minimum weighted average credit quality of either “A–” or better using either Moody’s or Standard & Poor’s credit ratings.

The credit quality ratings of bonds and notes and nonexchange commingled fixed income trust fund as of June 30, 2017, are as follows (in thousands):

| Investment type | Rating (1) | | | | | | CCC- | Not rated | Total |
|---|------------|------------|----------|--------------|------------|----------|--------|-----------|---------|
| | AAA | AA+ to AA- | A+ to A- | BBB+ to BBB- | BB+ to BB- | B+ to B- | | | |
| Bonds and notes: | | | | | | | | | |
| U.S. government sponsored agencies obligations: | | | | | | | | | |
| Federal Home Loan Bank (FHLB) \$ | — | 2,937 | — | — | — | — | — | — | 2,937 |
| Federal National Mortgage Association (FNMA) | — | 4,249 | — | — | — | — | — | — | 4,249 |
| Federal Home Loan Mortgage Corporation (FHLMC) | — | 927 | — | — | — | — | — | — | 927 |
| Federal Farm Credit Banks (FFCB) | — | 1,676 | — | — | — | — | — | — | 1,676 |
| Mortgage and asset-backed securities: | | | | | | | | | |
| FNMA | — | 2,581 | — | — | — | — | — | — | 2,581 |
| FHLMC | — | 1,420 | — | — | — | — | — | — | 1,420 |
| U.S. corporate bonds and notes | 2,065 | 10,832 | 13,245 | 34,770 | 473 | — | — | 3,554 | 64,939 |
| Non U.S. corporate bonds | — | 502 | 4,094 | 6,444 | 857 | — | — | 2,914 | 14,811 |
| COFINA bonds | — | — | — | — | — | — | 58,224 | — | 58,224 |
| Total | \$ 2,065 | 25,124 | 17,339 | 41,214 | 1,330 | — | 58,224 | 6,468 | 151,764 |

(1) Rating obtained from Standard and Poor’s or equivalent rating by Moody’s Investor Service or Fitch Ratings.

Approximately \$11.4 million of the total System investments consist of U.S. government and Government National Mortgage Association (GNMA) mortgage-backed securities, which carry no risk, therefore, not included within the above table.

(c) Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of the System’s investment in a single issuer. As of June 30, 2017, there are no investments in any issuer that represent 5% or more of the System’s total investments, except for its investment in COFINA Bonds.

Pursuant to Act No. 96 of June 16th, 2011, during the fiscal year ended June 30, 2011, the System received a special contribution of approximately \$163 million from the Puerto Rico Infrastructure Financing Authority, an instrumentality of the Commonwealth. The contribution was invested in bonds issued by the Puerto Rico Sales Tax Financing Corporation (known as COFINA by its Spanish acronym), which provide for a 7% accretion rate and maturity dates between 2043 and 2048. COFINA is a blended component unit of the Commonwealth. As required by Act No. 96 of June 16th, 2011, the System cannot voluntarily dispose the COFINA Bonds unless such request has been approved by the GDB. The COFINA Bonds have a fair value of approximately \$58.2 million as of June 30, 2017.

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(d) Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. In accordance with its investment policy, the System manages its exposure to declines in fair values by structuring the investment portfolio so that securities mature to meet cash requirements for benefit payments, thereby avoiding the need to sell securities on the open market prior to maturity. Investments in equity securities are not subject to the maximum maturity policy since they do not carry a maturity date. The System is expected to achieve capital preservation and income generation by investing in a diversified portfolio of marketable, investment grade intermediate credit and core fixed-income securities.

The contractual maturity of investments as of June 30, 2017, is summarized below (in thousands). Expected maturities will differ from contractual maturities, because counterparties may have the right to call or prepay obligations with or without call or prepayment penalties.

| Investment type | Maturity (in years) | | | | Total |
|---|---------------------|-------------------------|-------------------------|-----------------|---------|
| | Within one year | After one to five years | After five to ten years | After ten years | |
| Bonds and notes: | | | | | |
| U.S. government securities: | | | | | |
| U.S. Treasury notes | \$ 2,105 | 824 | 3,602 | — | 6,531 |
| U.S. Treasury bonds | — | — | — | 2,353 | 2,353 |
| U.S. government sponsored agencies obligations: | | | | | |
| FHLBC | — | 1,053 | 1,884 | — | 2,937 |
| FNMA | — | — | 4,249 | — | 4,249 |
| FHLMC | — | 927 | — | — | 927 |
| FFCBC | — | 1,676 | — | — | 1,676 |
| Mortgage and asset-backed securities: | | | | | |
| GNMA | — | — | — | 2,539 | 2,539 |
| FNMA | — | — | — | 2,581 | 2,581 |
| FHLMC | — | — | — | 1,420 | 1,420 |
| U.S. corporate bonds and notes | 9,854 | 31,014 | 23,993 | 78 | 64,939 |
| Non U.S. corporate bonds | 847 | 6,079 | 6,847 | 1,038 | 14,811 |
| COFINA bonds | — | — | — | 58,224 | 58,224 |
| Total bonds and notes | \$ 12,806 | 41,573 | 40,575 | 68,233 | 163,187 |

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| Investment type | Maturity (in years) | | | | Total |
|---|---------------------|-------------------------|-------------------------|-----------------|------------|
| | Within one year | After one to five years | After five to ten years | After ten years | |
| Nonexchange commingled equity trust funds and investments in limited partnerships: | | | | | |
| Nonexchange commingled equity trust funds: | | | | | |
| U.S. – SSgA Russell 3000 Fund | | | | | 120,498 |
| Non-U.S. – SSgA MSCI ACWI Ex USA Fund | | | | | 61,201 |
| Investments in limited partnerships | | | | | 87,069 |
| Total nonexchange commingled equity trust funds and investments in limited partnerships | | | | | 268,768 |
| Total investments | | | | | \$ 431,955 |

(1) Nonexchange commingled fixed income trust fund was classified based on effective duration.

(e) Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit. As of June 30, 2017, the SSgA MSCI ACWI Ex USA Fund is subject to foreign currency risk.

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As of June 30, 2017, the composition of the underlying investments in the SSgA MSCI ACWI Ex USA Fund by country was as follows:

| Country | SSgA MSCI ACWI EX USA Fund |
|----------------|----------------------------------|
| Japan | 16 % |
| United Kingdom | 11 |
| France | 7 |
| Canada | 7 |
| Germany | 7 |
| Switzerland | 6 |
| Australia | 5 |
| Hong Kong | 5 |
| China | 4 |
| Korea | 4 |
| Taiwan | 3 |
| Netherlands | 3 |
| Spain | 2 |
| India | 2 |
| Others | 18 |
| Total | 100 % |

(i) *Nonexchange Commingled Trust Funds*

As of June 30, 2017, the System owned shares in the SSgA Russell 3000 Index Non-Lending Fund (SSgA Russell 3000 Fund) and the SSgA MSCI ACWI Ex USA Non-Lending Fund (SSgA MSCI ACWI Ex USA Fund) as follows (in thousands):

| Fund name | Shares | Value |
|--|--------|------------|
| SSgA Russell 3000 Fund | 4,619 | \$ 120,498 |
| SSgA MSCI ACWI Ex USA Fund | 3,096 | 61,201 |
| Total nonexchange commingled trust funds | | \$ 181,699 |

The investment objective of the Russell 3000 Fund is to approximate as closely as practicable, before expenses, the performance of the Russell 3000 Index over the long term. Shares can be redeemed on a daily basis at NAV and have no redemption restrictions.

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The investment objective of the SSgA MSCI ACWI Ex USA Fund is to approximate as closely as practicable, before expenses, the performance of the MSCI ACWI ex USA Index over the long term. Shares can be redeemed semi-monthly at NAV and have no redemption restrictions.

As of June 30, 2017, the investments underlying the SSgA Russell 3000 Fund and the SSgA MSCI ACWI Ex USA Fund, had the following sector allocations:

| Sector | SSgA Russell 3000 Fund | SSgA MSCI ACWI Ex USA Fund |
|----------------------------|---------------------------|----------------------------------|
| Information technology | 21 % | 12 % |
| Financials | 15 | 22 |
| Healthcare | 14 | 8 |
| Consumer discretionary | 12 | 11 |
| Industrials | 11 | 12 |
| Consumer staples | 8 | 9 |
| Energy | 5 | 8 |
| Real Estate | 4 | 3 |
| Materials | 3 | 8 |
| Utilities | 3 | 3 |
| Telecommunication services | 2 | 4 |
| Unclassified | 2 | — |
| Total | 100 % | 100 % |

(ii) *Investments in Limited Partnerships*

The fair value of investments in limited partnerships at June 30, 2017, amounted to approximately \$87.0 million and is presented as private equity investments in the basic Statement of Fiduciary Net Position. The allocations of net gains and losses to limited partners are based on certain percentages, as established in the limited partnership agreements. Investments in limited partnerships are not rated by a nationally recognized statistical rating organization.

In accordance with the partnership agreements, the System's investments can only be redeemed upon distribution from funds managers; usually in the form of a sale of its holdings or dividends distributed. As of June 30, 2017, the System does not intend to sell its investments in limited partnerships for an amount different to that presented in the financial statements.

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As of June 30, 2017, the date of commitment, total commitment, 2017 contributions, contributions to date at cost, and estimated fair value of investments in limited partnerships are as follows (in thousands):

| | <u>Date of commitment</u> | <u>Total commitment</u> | <u>2017 Contributions</u> | <u>Contributions to date at cost</u> | <u>Estimated fair value</u> |
|---|-------------------------------|-----------------------------|-------------------------------|--|---------------------------------|
| Grupo Guayacán, Inc.- Guayacán Fund of Funds II, LP | August 1999 | \$ 25,000 | — | 23,681 | 919 |
| Advent-Morro Equity Partner, Inc.: Guayacán Private Equity Fund, LP | January 1997 | 5,000 | — | 4,645 | 2,162 |
| Guayacán Private Equity Fund II, LP | April 2007 | 25,000 | — | 24,547 | 22,638 |
| Venture Capital Fund, Inc. | November 1995 | 800 | — | 800 | 654 |
| GF Capital Management and Advisors, LLC – GF Capital Private Equity Fund LP | December 2006 | 25,000 | 97 | 25,890 | 19,225 |
| Chase Capital Partners Private: Equity Fund of Funds Corporate | July 2000 | 20,000 | — | 18,994 | — |
| Courage Credit | 2017 | 5,000 | 2,254 | 2,254 | 1,857 |
| Medley Credit Opportunity | 2017 | 15,000 | 12,953 | 12,953 | 12,530 |
| MCOY Investments | 2017 | 10,000 | 10,000 | 10,000 | 9,696 |
| Phoenix | 2017 | 10,000 | 10,000 | 10,000 | 9,641 |
| MCLarty Bluhaus Capital Partner | 2017 | 5,000 | 250 | 250 | 250 |
| Terracap | 2017 | 7,500 | 6,829 | 6,829 | 7,497 |
| Total | | \$ <u>153,300</u> | <u>42,383</u> | <u>140,843</u> | <u>87,069</u> |

(iii) *Securities Lending Transactions*

The System participates in a securities lending program, whereby securities are transferred to an independent broker or dealer in exchange for collateral in the form of cash, government securities, and/or irrevocable bank letters of credit with a simultaneous agreement to return the collateral for the same securities in the future. Collateral is marked to market daily and the agent places a request for additional collateral from brokers, if needed. The custodian bank is the agent for the securities lending program.

At the end of the year, there was no credit risk exposure to borrowers because the amounts the System owes the borrowers (the collateral) exceeded the amounts the borrowers owe the System (the securities lent). At June 30, 2017, the collateral received represented 103% of the fair value of the total securities lent.

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The securities on loan for which collateral was received as of June 30, 2017, consisted of the following (in thousands):

| <u>Description</u> | <u>Fair value of underlying securities</u> |
|---|--|
| U.S. government securities: | |
| U.S. Treasury bills | \$ 657 |
| U.S. Treasury notes | 892 |
| U.S. government sponsored agencies notes | 752 |
| U.S. corporate bonds and notes | <u>5,058</u> |
| Total | <u>\$ 7,359</u> |

The underlying collateral for these securities had a fair value of approximately \$7.4 million as of June 30, 2017. The collateral received was invested in a money market fund sponsored by the custodian bank. As of June 30, 2017, the short-term investment fund consisted of securities purchased under agreements to resell.

Under the terms of the securities lending agreement, the System is fully indemnified against failure of the borrowers to return the securities lent (to the extent the collateral is inadequate to replace the securities lent) or failure to pay the System for income distributions by the securities' issuers while the securities are on loan. In addition, the System is indemnified against loss should the lending agent fail to demand adequate and appropriate collateral on a timely basis.

(7) Accounts Receivable from Employers

As of June 30, 2017, accounts receivable from employers consisted of the following (in thousands):

| | |
|--|--------------------|
| Early retirement programs | \$ 1,865 |
| Special laws | 80,627 |
| Employer and employee contributions | 887,557 |
| Interest on late payments | <u>95,862</u> |
| Total accounts receivable from employers | 1,065,911 |
| Less allowance for adjustments and losses in realization | <u>(1,029,739)</u> |
| Total accounts receivable from employers – net | <u>\$ 36,172</u> |

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Under Act No. 447, each employer must pay, on a monthly basis, the amounts corresponding to contributions and loan repayments, on or before the fifteenth day of the following month. After that date, interest is charged as established by the System.

As more fully described in note 3, the Commonwealth and many of its instrumentalities, public corporations and municipalities, which are the employers of the System, have been facing significant fiscal and economic challenges. Further, prior to the commencement of the Title III Cases, the rating downgrade and widening of credit spreads for the Commonwealth's public sector and public corporations' debt put further strain on liquidity and sources of funding of the employers. Consequently, most of the receivables from employers are delinquent past established payment dates and/or installment plan due dates. In other instances, amounts past due have continued to be renegotiated to later dates.

As of June 30, 2017, the System recorded an allowance of approximately \$1,030 million for adjustments and losses in realization of the salary-based employer contributions and Additional Uniform Contributions due from the Commonwealth, public corporations and municipalities for the fiscal years 2016 and 2017 because, as explained in note 3, their collectability is uncertain.

(8) Member Loans and Interest Receivable

Loans receivable from plan members are guaranteed by the contributions of plan members and by other sources, including mortgage deeds and any unrestricted amount remaining in the escrow funds. In addition, collections on loans receivable are received through payroll withholdings. The latest maximum amount of loans to plan members for mortgage loans was \$100,000 and \$5,000 for personal and cultural trip loans. The originations of mortgage loans were frozen in December 2013 and those related to personal and cultural loans were frozen in November 2016. During the years ended June 30, 2014 and 2013, personal loans with principal balances amounting to approximately \$100 million and \$88 million, respectively, were sold to two financial institutions. As per servicing agreements, the System is in charge of the servicing, administration and collection of the loans and outstanding principal balances at and after closing date for a servicing fee of 2%.

The allowance for adjustments and losses in realization is considered a general allowance for all categories of loans and interest receivable, except mortgage loans, and also a specific allowance for the special collection project loans balances.

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As of June 30, 2017, the composition of loans and interest receivable from plan members is summarized as follows (in thousands):

| | | |
|---|----|-----------------------|
| Loans receivable: | | |
| Personal | \$ | 298,879 |
| Mortgage | | 161,495 |
| Cultural trips | | <u>36,859</u> |
| Total loans to plan members | | 497,233 |
| Accrued interest receivable | | 29,085 |
| Less allowance for adjustments and losses in realization | | <u>(2,875)</u> |
| Total loans and interest receivable from plan members – net | \$ | <u><u>523,443</u></u> |

(9) Other Assets

As of June 30, 2017, other assets mainly consist of repossessed and foreclosed properties acquired through foreclosure proceedings related to delinquent mortgage loans. Foreclosed properties are valued at the outstanding principal balance of the related mortgage loan upon foreclosure. These properties will be sold under a bidding process intended to recover the outstanding principal balance of the related mortgage loan. A gain or loss will be recognized at the time of sale.

Differences resulting from the recognition of losses at the point of sale rather than upon foreclosure, as required by GAAP, are not material. Management believes that the carrying value of these properties approximates fair value.

(10) Bonds Payable

Senior Pension Funding Bonds – On February 27, 2007, the System’s administration and GDB, acting as the System’s fiscal agent (the Fiscal Agent), presented to the Board of Trustees, a financial transaction for the issuance of pension funding bonds in order to reduce the System’s unfunded actuarial accrued liability. The Bonds are limited, nonrecourse obligations of the System, payable solely from and secured solely by a pledge of employer contributions, as defined in the ERS Bond Resolution, made after the date of issuance of the first series of Bonds, and from funds held on deposit with the Bank of New York (the Fiscal Agent). The Bonds are not payable from contributions made to the System by participating employees, or from the assets acquired with the proceeds of the Bonds, or from employer contributions released by the Fiscal Agent to the System after funding of required reserves, or from any other assets of the System. The System invested the proceeds of the Bonds and used these investments and the earnings thereon to provide pension benefits to its beneficiaries.

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On January 31, 2008, the System issued the first series of Bonds, which consisted of approximately \$1,589 million aggregate principal amount of Senior Pension Funding Bonds, Series A (the Series A Bonds). On June 2, 2008, the System issued the second of such series of Bonds, which consisted of approximately \$1,059 million aggregate principal amount of Senior Pension Funding Bonds, Series B (the Series B Bonds). Finally, on June 30, 2008, the System issued the third and final of such series of Bonds, which consisted of approximately \$300 million aggregate principal amount of Senior Pension Funding Bonds, Series C (the Series C Bonds).

The following is a summary of changes in the bonds payable principle balance (in thousands):

| | <u>Maturity</u> | <u>Balance at June 30, 2016</u> | <u>Accretion</u> | <u>Balance at June 30, 2017</u> |
|---|-----------------|-------------------------------------|------------------|-------------------------------------|
| 5.85% to 6.45% Term and Capital Appreciation Bonds Series A | 2021–2058 | \$ 1,619,072 | 4,740 | 1,623,812 |
| 6.25% to 6.55% Term and Capital Appreciation Bonds Series B | 2028–2058 | 1,220,285 | 26,371 | 1,246,656 |
| 6.15% to 6.50% Term and Capital Appreciation Bonds Series C | 2028–2043 | 301,678 | 241 | 301,919 |
| Bond discounts | | <u>(6,133)</u> | <u>218</u> | <u>(5,915)</u> |
| Total | | \$ <u>3,134,902</u> | <u>31,570</u> | <u>3,166,472</u> |

As of June 30, 2017, the outstanding principal balance of the Bonds is as follows (in thousands):

| <u>Description</u> | |
|---|------------------|
| Series A Bonds: | |
| Capital Appreciation Bonds, maturing in 2028, bearing interest at 6.20% | \$ 80,042 |
| Term Bonds, maturing from 2021 through 2023, bearing interest at 5.85% | 200,000 |
| Term Bonds, maturing from 2031 through 2038, bearing interest at 6.15% | 679,000 |
| Term Bonds, maturing from 2039 through 2042, bearing interest at 6.20% | 332,770 |
| Term Bonds, maturing from 2055 through 2058, bearing interest at 6.45% | <u>332,000</u> |
| Total Series A Bonds outstanding | <u>1,623,812</u> |

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| Description | |
|--|---------------------|
| Series B Bonds: | |
| Capital Appreciation Bonds, maturing from 2028 through 2030, bearing interest at 6.40% | \$ 198,959 |
| Capital Appreciation Bonds, maturing from 2031 through 2034, bearing interest at 6.45% | 231,597 |
| Term Bonds, maturing in 2031, bearing interest at 6.25% | 117,100 |
| Term Bonds, maturing from 2036 through 2039, bearing interest at 6.30% | 270,000 |
| Term Bonds, maturing from 2055 through 2058, bearing interest at 6.55% | 429,000 |
| Total Series B Bonds outstanding | <u>1,246,656</u> |
| Series C Bonds: | |
| Capital Appreciation Bonds, maturing in 2030, bearing interest at 6.50% | 3,919 |
| Term Bonds, maturing from 2024 through 2028, bearing interest at 6.15% | 110,000 |
| Term Bonds, maturing from 2029 through 2038, bearing interest at 6.25% | 45,000 |
| Term Bonds, maturing from 2039 through 2043, bearing interest at 6.30% | 143,000 |
| Total Series C Bonds outstanding | <u>301,919</u> |
| Total bonds outstanding | 3,172,387 |
| Less bonds discount | <u>(5,915)</u> |
| Bonds payable – net | <u>\$ 3,166,472</u> |

Series A Bonds – The aggregate principal amount of the Series A Bonds issued amounted to approximately \$1,589 million of which \$1,544 million were issued as term bonds (the Series A Term Bonds) and \$45 million were issued as capital appreciation bonds (the Series A Capital Appreciation Bonds). Interest in the Series A Term Bonds are payable monthly on the first day of each month. Interest on the Series A Capital Appreciation Bonds are not payable on a current basis but are added to the principal of the Capital Appreciation Bonds on each January 1 and July 1 (Compounding Dates), and are treated as if accruing in equal daily amounts between Compounding Dates, until paid at maturity or upon redemption. Interest shall be computed on the basis of a 360 day year consisting of twelve 30 day months.

The Series A Bonds are subject to redemption at the option of the System from any source, in whole or in part at any time on or after July 1, 2018, at a redemption price equal to the principal amount (in the case of Series A Capital Appreciation Bonds, the accreted amount) of the Series A Bonds, plus accrued interest to the redemption date, and without premium.

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In addition, the following Series A Term Bonds are subject to mandatory redemption in part commencing on July 1, 2021 to the extent of the sinking fund requirement for said bonds set forth below at a redemption price equal to 100% of the principal amount thereof plus accrued interest as follows (in thousands):

| Redemption period | Subject bonds | Amount |
|-------------------|--|------------|
| July 1, 2021 | Term bonds (final maturity July 1, 2023) | \$ 50,000 |
| July 1, 2022 | Term bonds (final maturity July 1, 2023) | 70,000 |
| July 1, 2023 | Term bonds (final maturity July 1, 2023) | 80,000 |
| | Subtotal | 200,000 |
| July 1, 2031 | Term bonds (final maturity July 1, 2038) | 3,000 |
| July 1, 2032 | Term bonds (final maturity July 1, 2038) | 4,500 |
| July 1, 2033 | Term bonds (final maturity July 1, 2038) | 4,000 |
| July 1, 2034 | Term bonds (final maturity July 1, 2038) | 133,500 |
| July 1, 2035 | Term bonds (final maturity July 1, 2038) | 133,500 |
| July 1, 2036 | Term bonds (final maturity July 1, 2038) | 133,500 |
| July 1, 2037 | Term bonds (final maturity July 1, 2038) | 133,500 |
| July 1, 2038 | Term bonds (final maturity July 1, 2038) | 133,500 |
| | Subtotal | 679,000 |
| Total | | \$ 879,000 |

Series B Bonds – The aggregate principal amount of the Series B Bonds amounted to approximately \$1,059 million of which \$816 million were issued as term bonds (the Series B Term Bonds) and \$243 million were issued as capital appreciation bonds (the Series B Capital Appreciation Bonds). Interest in the Series B Term Bonds are payable monthly on the first day of each month. Interest on the Series B Capital Appreciation Bonds are not payable on a current basis but are added to the principal of the Series B Capital Appreciation Bonds on each January 1 and July 1 (Compounding Dates), and are treated as if accruing in equal daily amounts between Compounding Dates, until paid at maturity or upon redemption. Interest shall be computed on the basis of a 360 day year consisting of twelve 30 day months.

The Series B Bonds are subject to redemption at the option of the System from any source, in whole or in part at any time on or after July 1, 2018, at a redemption price equal to the principal amount (in the case of Series B Capital Appreciation Bonds, the accreted amount) of the Series B Bonds, plus accrued interest to the redemption date, and without premium.

Series C Bonds – The aggregate principal amount of the Series C Bonds amounted to approximately \$300 million of which \$298 million were issued as term bonds (the Series C Term Bonds) and \$2 million were issued as capital appreciation bonds (the Series C Capital Appreciation Bonds). Interest in the Series C Term Bonds are payable monthly on the first day of each month. Interest on the Series C Capital Appreciation Bonds are not payable on a current basis, but are added to the principal of the Series C Capital Appreciation Bonds on each January 1 and July 1 (Compounding Dates), and are treated as if

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accruing in equal daily amounts between Compounding Dates, until paid at maturity or upon redemption. Interest shall be computed on the basis of a 360 day year consisting of twelve 30 day months.

The Series C Bonds are subject to redemption at the option of the System from any source, in whole or in part at any time on or after July 1, 2018, at a redemption price equal to the principal amount (in the case of Series C Capital Appreciation Bonds, the accreted amount) of the Series C Bonds, plus accrued interest to the redemption date, and without premium.

In addition, the following Series C Term Bonds are subject to mandatory redemption in part commencing on July 1, 2024 to the extent of the sinking fund requirement for said bonds set forth below at a redemption price equal to 100% of the principal amount thereof plus accrued interest as follows (in thousands):

| Redemption period | Subject bonds | Amount |
|-------------------|--|--------------------------|
| July 1, 2024 | Term bonds (final maturity July 1, 2028) | \$ 18,700 |
| July 1, 2025 | Term bonds (final maturity July 1, 2028) | 22,000 |
| July 1, 2026 | Term bonds (final maturity July 1, 2028) | 29,150 |
| July 1, 2027 | Term bonds (final maturity July 1, 2028) | 36,300 |
| July 1, 2028 | Term bonds (final maturity July 1, 2028) | <u>3,850</u> |
| | Subtotal | <u>110,000</u> |
| July 1, 2029 | Term bonds (final maturity July 1, 2038) | 100 |
| July 1, 2030 | Term bonds (final maturity July 1, 2038) | 540 |
| July 1, 2031 | Term bonds (final maturity July 1, 2038) | 100 |
| July 1, 2032 | Term bonds (final maturity July 1, 2038) | 3,420 |
| July 1, 2033 | Term bonds (final maturity July 1, 2038) | 4,320 |
| July 1, 2034 | Term bonds (final maturity July 1, 2038) | 100 |
| July 1, 2035 | Term bonds (final maturity July 1, 2038) | 11,940 |
| July 1, 2036 | Term bonds (final maturity July 1, 2038) | 2,160 |
| July 1, 2037 | Term bonds (final maturity July 1, 2038) | 7,920 |
| July 1, 2038 | Term bonds (final maturity July 1, 2038) | <u>14,400</u> |
| | Subtotal | <u>45,000</u> |
| July 1, 2039 | Term bonds (final maturity July 1, 2043) | 28,600 |
| July 1, 2040 | Term bonds (final maturity July 1, 2043) | 28,600 |
| July 1, 2041 | Term bonds (final maturity July 1, 2043) | 28,600 |
| July 1, 2042 | Term bonds (final maturity July 1, 2043) | 28,600 |
| July 1, 2043 | Term bonds (final maturity July 1, 2043) | <u>28,600</u> |
| | | <u>143,000</u> |
| Total | | \$ <u><u>298,000</u></u> |

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Debt service requirements in future years on the System's bonds as of June 30, 2017 are as follows (in thousands):

| | <u>Principal</u> | <u>Interest</u> | <u>Total</u> |
|----------------------|---------------------|---------------------|------------------|
| Year ending June 30: | | | |
| 2018 | \$ — | 166,519 | 166,519 |
| 2019 | — | 166,519 | 166,519 |
| 2020 | — | 166,519 | 166,519 |
| 2021 | — | 166,519 | 166,519 |
| 2022 | — | 166,519 | 166,519 |
| 2023–2027 | 200,000 | 751,232 | 951,232 |
| 2028–2032 | 1,036,595 | 702,754 | 1,739,349 |
| 2033–2037 | 452,745 | 695,887 | 1,148,632 |
| 2038–2042 | 1,210,220 | 407,702 | 1,617,922 |
| 2043–2047 | 180,550 | 256,577 | 437,127 |
| 2048–2052 | — | 247,568 | 247,568 |
| 2053–2057 | 362,800 | 212,062 | 574,862 |
| 2058–2062 | 398,200 | 14,401 | 412,601 |
| | 3,841,110 | \$ <u>4,120,778</u> | <u>7,961,888</u> |
| Less: | | | |
| Unaccreted interest | (668,723) | | |
| Unamortized discount | <u>(5,915)</u> | | |
| Total | \$ <u>3,166,472</u> | | |

Pledge of Employer Contributions Pursuant to Security Agreement – The System entered into a Security Agreement with the Fiscal Agent for the benefit of the bondholders, pursuant to which the System pledged to the Fiscal Agent, and granted the Fiscal Agent a security interest in employer contributions, as defined in the ERS Bond Resolution, made after January 31, 2008, which was the date of issuance of the first series of bonds, and the funds on deposit with the Fiscal Agent under the various accounts established under the Pension Funding Bond Resolution (the Resolution).

The Resolution and the Security Agreement constitute a contract between the System and the Fiscal Agent, on behalf of the owners of the bonds. The pledge, covenants and agreements of the System set forth in the Resolution and the Security Agreement shall be for the equal benefit, protection and security of the owners of the bonds, regardless of time or times of their issuance or maturity, and shall be of equal rank, without preference, priority or distinction of any of the bonds over any other bond, except as expressly provided in or permitted by the Resolution. Annual employer contributions that are made after January 31, 2008, which was the date of issuance of the first series of bonds, in accordance with the Act and amounts on deposit in the different accounts created pursuant to the Resolution for the benefits of the owners of the

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bonds, are pledged for annual debt service requirements as established. The pledge is irrevocable so long as any bonds are outstanding under the terms of the Resolution.

Starting in August 2016, and monthly thereafter, the Fiscal Agent under the Resolution of the System's bonds notified to the System that it failed to transfer the requisite employers' contributions on the last business day of each month. The Fiscal Agent is not seeking to collect or recover any indebtedness from, enforce any judgment against, or obtain possession of, exercise control over, any property of or from, the Commonwealth or any of its instrumentalities, including the System, or exercise any act that is stayed by PROMESA, the Puerto Rico Financial Emergency and Fiscal Responsibility Act of January 29, 2017 (Act No. 5 or the Financial Emergency Act), the Puerto Rico Emergency Moratorium and Financial Rehabilitation Act (Act No. 21 or the Moratorium Act), or any Executive Orders related thereto. The Fiscal Agent, however, has filed a proof of claim against the Commonwealth and the System in their respective Title III cases seeking the total aggregate amount of the outstanding System bonds. As discussed further in note 13, the validity of the System's bonds is currently being challenged in the Title III Court.

Bonds Credit Rating Downgrades - On June 24, 2016, Fitch Ratings Inc. downgraded the System's Bonds from "CC" to "C" and placed them on "negative" outlook. Fitch cited "the breakdown of negotiations between the Commonwealth and major bondholders, the recent ruling by the U.S. Supreme Court on the Commonwealth's bankruptcy legislation, and the slow process of federal legislation in support of the Commonwealth as indicators that a debt restructuring, deferral or default has become inevitable. On April 5, 2017, Moody's Investors Service downgraded the System's Bonds to from "C" to "Ca" and placed them on "negative" outlook, citing "persistent pressures on Puerto Rico's economic base that indicate a diminishing perceived capacity to repay." Standard & Poor's Ratings Services currently rates the System's Bonds at "CC."

(11) Guarantee Insurance Reserve for Member Loans

The System provides life insurance that guarantees the payment of the outstanding principal balance of mortgage, personal and cultural trip loans in case of death of a plan member. The plan members who obtained these loans from the System pay the coverage in its entirety. The life insurance rates are actuarially determined and do not vary by age, sex, or health status.

(12) Other Postemployment Healthcare Benefits Funded Status and Funding Progress

The System's other postemployment healthcare benefits (OPEB) funded status as of June 30, 2017, the most recent actuarial valuation date, is as follows (dollars in thousands):

| Actuarial value of plan assets | Actuarial Accrued Liability (AAL) | Unfunded Actuarial Accrued Liability (UAAL) | Funded ratio | Annual covered payroll | UAAL as a percentage of annual covered payroll |
|--------------------------------|--|---|--------------|------------------------|--|
| \$ — | 1,138,309 | 1,138,309 | — % | \$ 3,344,197 | 34.0 % |

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The schedule of funding progress, presented as required supplementary information following the notes to the basic financial statements, presents multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the AAL for benefits.

Act No. 3 eliminated the medical insurance plan contribution of \$100 per month for future retirees effective July 1, 2013.

The census data collection date is at the beginning-of-fiscal-year. The liability results as of June 30, 2017 are based on projecting the System obligations determined as of the census data collection date of July 1, 2016 for one year, using roll-forward methods and assuming no liability gains or losses. The amortization period for GASB Statement No. 45 has been reduced to the expected future lifetime of current in pay members.

The actuarial valuations used the following actuarial assumptions:

| | |
|-------------------------------|--|
| Actuarial cost method | Entry age normal |
| Amortization method | 18 years closed (beginning July 1, 2014), level dollar |
| Remaining amortization period | 16 years |
| Asset valuation method | Not applicable |
| Actuarial assumptions: | |
| Investment rate of return | 3.00% |
| Projected salary increases | Not applicable |
| Projected payroll growth | Not applicable |
| Inflation | Not applicable |
| Cost of living adjustment | Not applicable |

Actuarial valuations of an ongoing plan involve estimates of the net value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment and mortality. Amounts determined are subject to continuous revision as actual results are compared with past expectations and new estimates are made about the future.

Calculations are based on the types of benefits provided under the terms of the substantive plan at the time of each valuation and on the pattern of sharing of costs between the employer and plan members to that point. The projection of OPEB for financial reporting purposes does not explicitly incorporate the potential effects of legal or contractual funding limitations on the pattern of cost sharing between the employer and plan members in the future.

The actuarial calculations reflect a long-term perspective. Consistent with that perspective, actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and actuarial value of assets.

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The OPEB mortality rate assumptions are the same as that for pension benefits. For additional information refer to note 5.

(13) Contingencies

A. Litigation Filed by Creditors Against the System Before Commencement of the Title III Case

Administración de los Sistemas de Retiro de los Empleados del Gobierno y la Judicatura de Puerto Rico, et. al v. UBS Fin. Servs. Inc. of Puerto Rico, et al., Civ. No. KAC-2011-1067 (803) (P.R. Ct. of First Instance Sept. 29, 2011)

On September 29, 2011, two System beneficiaries commenced a derivative suit in the Commonwealth of Puerto Rico Court of First Instance, San Juan Part (the Commonwealth Court), alleging breach of fiduciary duties and breach of contract against the underwriters in the issuance and underwriting of \$3 billion of the System Bonds in 2008 (the UBS Action). On December 7, 2016, the Commonwealth Court allowed the System to intervene and ordered the plaintiffs, which now include the System and seven individual plaintiffs (collectively, the Plaintiffs), to file a third amended complaint against the underwriters, including UBS Financial Services Inc. of Puerto Rico (UBS), and related entities (collectively, the UBS Defendants). UBS had served as the lead underwriter of the 2008 System Bonds.

Among other things, Plaintiffs allege that by participating as the lead underwriter of the 2008 System Bonds, UBS violated its contractual, non-contractual and fiduciary obligations to the System. The Plaintiffs seek a ruling that UBS is liable to the System for over \$800 million for underwriting the 2008 System Bonds.

On March 6, 2019, Plaintiffs filed the Fourth Amended Complaint against the UBS Defendants, which was accepted by the Commonwealth Court on April 15, 2019. On April 29, 2019, UBS filed its answer and an informative motion regarding its intent to file a counterclaim if the System's Title III automatic stay were to be lifted. The proposed counterclaim attached to the informative motion alleges breach of contract and indemnification arising out of the System's issuance of the 2008 System Bonds.

On June 25, 2019, the Oversight Board filed a motion to stay certain contested matters pending confirmation of a proposed plan of adjustment for the Commonwealth. On July 24, 2019, the Title III Court entered an order staying until November 30, 2019, various adversary proceedings and claims objections before it with overlapping issues, including those involving the validity of the System Bond issuances. UBS contends that the UBS Action in the Commonwealth Court should be stayed pending the Title III Court's resolution of alleged common legal issues.

On October 8, 2019, UBS filed a motion for relief from the automatic stay in order to assert counterclaims in the Commonwealth Court for breach of contract and indemnification against the System in the UBS Action. UBS asserts that the System represented in the 2008 System Bond Offering Statements that it was issuing the 2008 System Bonds in accordance with the authority provided under the Retirement Act, and that the 2008 System Bonds would be legally binding special obligations of the System. UBS also argues that the System represented in the purchase contracts entered into with UBS that the System had full right, power and legal authority to issue the bonds, and it was not in violation of

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any law On December 11, 2019, the Title III Court held a hearing on UBS's stay relief motion. On December 16, 2019, the Title III Court granted UBS limited relief from the stay solely to allow UBS to present its proposed counterclaims in the Commonwealth Court. On February 4, 2020, UBS submitted its counterclaims in the Commonwealth Court. On March 9, 2020, the Oversight Board filed its objections to the counterclaims. On March 30, 2020, UBS renewed its stay relief motion, arguing that the Oversight Board's objection to the counterclaims violated the December limited lift-stay order and the Commonwealth Court should now be free to hear the Oversight Board's objections. On April 22, 2020, the Title III Court denied the motion.

UBS has also filed two proofs of claim against the System related to the UBS Action, as well as two proofs of claim related to *Casasnovas Balado v. UBS Fin. Servs., Inc.*, No. K AC-2014-0072 (905) (P.R. Ct. of First Instance Jan. 29, 2016), an action filed by a group of individual plaintiffs arising from the System Bond issuances.

B. Litigation Filed by Creditors Against the System After Commencement of the Title III Case

Employees Ret. Sys. of the Gov't of the Commonwealth of Puerto Rico, et al. v. Altair Global Credit Opportunities Fund (A), LLC, et al., Adv. Pro. No. 17-00213 (D.P.R. July 21, 2017)

On July 21, 2017, the Oversight Board, as representative of the System in its Title III case, commenced an adversary proceeding challenging the System bondholders' security interests in various system assets through a declaratory relief action (the System Declaratory Relief Action). Through the System Declaratory Relief Action, the Oversight Board, as representative of the System in the Title III case, sought declaratory relief challenging the validity, priority, extent, and enforceability of the prepetition and postpetition liens and security interests asserted by defendants with respect to bonds issued by the System. The complaint contends that the System bondholders' alleged liens and security interests are not perfected because the required UCC financing statements and subsequent amendments were defective, and therefore the liens could be avoided in the Title III case. The System Declaratory Relief Action also challenged, among other things, the System bondholders' alleged security interest in postpetition employer contributions.

On August 17, 2018, the Title III Court granted partial summary judgment in favor of the System. The Title III Court held, among other things, that the System bondholders' liens are not perfected and their security interests are avoidable under Bankruptcy Code section 544. On September 5, 2018, the Title III Court entered an order dismissing the remaining counts and counterclaims. This decision was appealed to the United States Court of Appeals for the First Circuit.

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On January 30, 2019, the First Circuit (i) affirmed the Title III Court's holding that the 2018 financing statements related to the System's bonds did not perfect the System bondholders' security interest in pledged property, (ii) affirmed the dismissal of the System bondholders' claim regarding a January 2017 stipulation, and (iii) reversed the Title III Court by finding that the System bondholders met the requirement for perfection beginning on December 17, 2015. In addition, the First Circuit remanded certain counterclaims to the Title III Court for further consideration. On April 30, 2019, the Oversight Board, on behalf of the System, filed a petition for a *writ of certiorari* with the United States Supreme Court, seeking to reverse the First Circuit's decision. The petition was denied on October 7, 2019.

On remand, the System requested that the Title III Court (i) determine the undecided issue of whether the System bondholders' security interests attach to revenues received by the System after commencement of its Title III case (the Post-Petition Revenue Issue) and (ii) grant it leave to file an amended adversary complaint to raise issues concerning the nature or extent of the System bondholders' security interests. On May 6, 2019, the Title III Court agreed to determine the Post-Petition Revenue Issue, but denied the System's request for leave to amend its complaint. On June 27, 2019, the Title III Court granted summary judgment in favor of the System on the Post-Petition Revenue Issue, holding that Bankruptcy Code section 552 prevents the System bondholders' security interests from attaching to revenues received by the System post-petition, and finding that employers' contributions are not "special revenues" within the meaning of Bankruptcy Code section 902. On July 18, 2019, the System's bondholders appealed the Title III Court's decision to the United States Court of Appeals for the First Circuit. On January 30, 2020, the First Circuit issued an opinion affirming the Title III Court's decision. On March 3, 2020, the First Circuit denied the System bondholders petition for rehearing *en banc*.

Andalusian Global Designated Activity Co., et al. v. Commonwealth of Puerto Rico, et al., Adv. Pro. Nos. 17-00219-LTS, 17-00220-LTS (D.P.R. July 27, 2017)

On July 27, 2017, a group of System bondholders commenced adversary proceedings against the Commonwealth and the System in the cases initially captioned as *Altair Global Credit Opp. Fund (A), LLC, et al. v. Commonwealth of Puerto Rico, et al.*, Adv. Pro. Nos. 17-00219-LTS, 17-00220-LTS (D.P.R. July 27, 2017) (collectively, the PayGo Litigation), seeking a declaration that Joint Resolution 188 and Act 106-2017 (collectively, the PayGo Statute) are void *ab initio* because they violate the Title III automatic stay and the Contracts Clause and Takings Clause of the United States Constitution.

On November 17, 2017, the Oversight Board, as representative of the System in its Title III case and joined by FAFAA and the Retiree Committee, filed a motion to dismiss the PayGo Litigation. On February 2, 2018, the Title III Court issued an order informing the parties that the motion to dismiss would be taken under submission. On September 9, 2018, the Title III Court stayed the case pending the United States Court of Appeals for the First Circuit's decision on the summary judgment appeal in the System Declaratory Relief Action, which decision was rendered on January 30, 2019 (as discussed above). In light of the stay, on September 27, 2018, the Title III Court terminated the motion to dismiss without prejudice to its restoration on request following termination of the stay. No parties have moved to lift the stay.

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On March 1, 2019, the Title III Court dismissed this case without prejudice as to Altair Global Credit Opportunities Fund (A), LLC and Nokota Capital Master Fund, L.P. As a result, the case was re-captioned *Andalusian Global Designated Activity Co. et al v. Commonwealth of Puerto Rico, et al.*, Adv. Pro. Nos. 17-00219-LTS, 17-00220-LTS (D.P.R.). On March 5, 2019, the Title III Court entered an order allowing certain System Bondholders – Crown Managed Accounts (for and on behalf of Crown/PW SP), LMA SPC (for and on behalf of Map 98 Segregated Portfolio), Oceana Master Fund Ltd., Pentwater Merger Arbitrage Master Fund Ltd., and PWCM Master Fund Ltd. – to intervene in the adversary proceeding. On October 25, 2019, these System Bondholders filed a motion to inform filing of a response to certain arguments concerning the validity of bonds issued by the System in the omnibus claims objections of the Creditors' Committee and the Retiree Committee, as well as in the motion to dismiss. As of the date of these financial statements, there has been no further docket activity.

C. Key Contested Matters in the System's Title III Case

Appointments Clause Litigation, Case No. 17-3566-LTS (D.P.R. Aug. 7, 2017)

On August 7, 2017, a group of GO bondholders led by Aurelius Investment, LLC, Aurelius Opportunities Fund, LLC, and Lex Claims, LLC (collectively, Aurelius) filed a motion to dismiss the Title III petitions. In the motion, Aurelius argued that the appointment of the Oversight Board members violated the "Appointments Clause" of the United States Constitution, which requires that "principal officers" of the United States be appointed by the President and confirmed by the Senate. The Title III Court denied Aurelius' motion to dismiss, and Aurelius appealed to the United States Court of Appeals for the First Circuit. On February 15, 2019, the First Circuit reversed the Title III Court, holding that the Oversight Board members' appointment process violated the Appointments Clause. The First Circuit stayed its ruling for 90 days to allow the President and Senate to appoint the members of the Oversight Board in accordance with the United States Constitution. It also expressly validated all of the Oversight Board's past actions, including any actions taken by the Oversight Board during the 90-day stay period.

On April 23, 2019, the Oversight Board appealed the First Circuit's decision to the United States Supreme Court by filing a petition for a writ of certiorari. On April 24, 2019, the Oversight Board filed a motion in the First Circuit requesting an extension of the 90-day stay of its February 15 decision until the Supreme Court's final disposition of the case. On May 6, 2019, the First Circuit granted in part the Oversight Board's extension motion by extending the stay of its February 15 decision until July 15, 2019, but denied the request to extend the stay indefinitely until the Supreme Court's final disposition of the case.

On May 30, 2019, Aurelius filed a cross petition for a writ of certiorari in the United States Supreme Court to challenge the First Circuit's validation of the Oversight Board's past actions under the de facto officer doctrine. On June 6, 2019, the Solicitor General of the United States and the Creditors' Committee each filed separate petitions for writs of certiorari in the United States Supreme Court to address whether the members of the Oversight Board are "Officers of the United States" within the meaning of the Appointments Clause. On June 14, 2019, Unión de Trabajadores de la Industria Eléctrica y Riefo (UTIER) – the plaintiff in a related adversary proceeding under Case Nos. 17-00228 –

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LTS – filed its own separate petition for a writ of certiorari in the United States Supreme Court to challenge the First Circuit's application of the de facto officer doctrine.

On June 18, 2019, the President of the United States re-nominated all seven original Oversight Board members to complete the remainder of their terms, and these nominations are currently pending before the United States Senate.

On June 20, 2019, the United States Supreme Court granted the Oversight Board, Aurelius, Solicitor General, Creditors' Committee, and UTIER petitions for writs of certiorari and stayed the First Circuit decision pending its final determination. Oral argument on the appeal was heard before the United States Supreme Court on October 15, 2019. As of the date of these financial statements, the Supreme Court has not yet entered its decision on the appeal.

Motion of Certain Secured Creditors of the System for Relief from the Automatic Stay, Case No. 17-3566-LTS (D.P.R. July 3, 2018)

On July 3, 2018, a group of System bondholders (including Altair Global, Andalusian Global, Glendon Opportunities Fund, Mason Capital, Nokota Capital, Oaktree, Ocher Rose, SV Credit and a number of Puerto Rico-based mutual funds) filed a motion (the Stay Relief Motion) in the System's Title III case arguing that the Prepetition Segregated Account would run out of funds in August 2018, depriving bondholders of adequate protection in the form of monthly interest payments and therefore leaving movants' constitutionally-protected property interests unprotected. Movants asserted that relief from the Title III stay was necessary in order to maintain the status quo pending the Title III Court's resolution of the cross-motions for summary judgment in the System Declaratory Relief Action (discussed above). In the alternative, movants requested adequate protection of their liens on property of the System. On August 21, 2018, the Title III Court denied the Stay Relief Motion, and on August 29, 2018, the System bondholders filed an appeal to the United States Court of Appeals for the First Circuit.

On February 21, 2019, movants renewed their Stay Relief Motion following the First Circuit's January 30, 2019 reversal, in part, of the Title III Court's August 17, 2018 order in the System Declaratory Relief Action. In light of the Title III Court's June 27, 2019 decision in the System Declaratory Relief Action, the Title III Court terminated the renewed Stay Relief Motion without prejudice on July 8, 2019.

Omnibus Objections to System Bondholder Claims, Case No. 17-3566-LTS

On March 12, 2019, the Creditors' Committee filed an omnibus objection to all claims asserted against the System based on the approximately \$3.1 billion of outstanding bonds issued by the System in 2008 (the Creditors' Committee System Bond Claims Objection). The Creditors' Committee System Bond Claims Objection argues that the System was only authorized to issue a "direct placement of debts," which the Creditors' Committee claims means a "private placement, not a public offering." Because the System Bonds were issued in a public offering, the Creditors' Committee asserts that the System Bonds were *ultra vires* and are thus "null and void." As a result, the Creditors' Committee seeks an order disallowing all System bond claims in their entirety. Also on March 12, 2019, the Creditors'

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Committee filed a procedures motion related to the adjudication of the Creditors' Committee System Bond Claims Objection.

On April 23, 2019, the Retiree Committee filed an omnibus objection (the Retiree Committee System Bond Claims Objection) to all System bondholder claims asserted against both the System and the Commonwealth on the grounds that the System Bonds were issued *ultra vires* and that the System bondholders have no enforceable claim with respect to the System Bonds.

On July 24, 2019, the Title III Court entered an order (the July 24 Stay Order) staying the Creditors' Committee System Bond Claims Objection and Retiree Committee System Bond Claims Objection (together, the "System Bond Claims Objections").

On October 18, 2019, the parties to the System Bond Claims Objections jointly filed a motion and stipulated order seeking to modify the July 24, Stay Order by allowing for the *ultra vires* issues and lien-scope issues raised in the objections to proceed. On October 24, 2019, the Title III Court has not yet entered the stipulated order granted the motion and established a discovery and briefing schedule related to the *ultra vires* and lien-scope issues through May 2020. On October 28, 2019, the Title III Court entered an order requiring a mediation report and/or scheduling order as to the remaining stayed matters by November 27, 2019 and extended the stay through December 31, 2019 as to all other matters not related to the *ultra vires* and lien-scope issues. On November 27, 2019, the court – appointed mediation team filed an interim status report, which provided recommended scheduling and sequencing of certain key litigation issues, including (i) the validity of certain challenged series of GO and PBA bonds; (ii) the secured or unsecured status of claims on GO and PBA bonds; and (iii) the rights, as against the Commonwealth, of holders of revenue bonds and other debt issued by certain Puerto Rico instrumentalities. Under the proposed scheduling order contained in the interim status report, the mediation team has proposed initial briefing on these issues to commence in February 2020 with hearings scheduled on April 30, 2020 and in June 2020. On December 27, 2019, the Title III Court entered an amended order extending the stay through March 11, 2020. On February 10, 2020, the mediation team filed an amended report, which the Title III Court considered at a hearing held on March 4, 2020. On March 10, 2020, the Title III Court entered a final order on the stay period, authorizing certain lift stay motions and revenue bond complaints to proceed but otherwise kept the stay in place for proceedings that do not involve *ultra vires* and/or lien-scope issues pending the Title III Court's decision on confirmation of the Amended Plan (defined below).

On January 6, 2020, the Oversight Board and Creditors' Committee filed several additional objections to the proofs of claim filed by the System Fiscal Agent and System bondholders. The Oversight Board filed an objection to the System Fiscal Agent's proof of claim, which asserts a claim for approximately \$3.8 billion in principal, \$9.2 million in accrued but unpaid interest, and other fees and expenses. Referencing the System Bond Claims Objections, the Oversight Board argues that the System Fiscal Agent's claim should be disallowed because the bonds were issued *ultra vires*, but even if the issuance was not *ultra vires* the Fiscal Agent is undersecured and is only entitled to assets in which the Fiscal Agent has a security interest and can be traced (if any). The Oversight Board also filed objections to the System bondholders' proofs of claim against the System, similarly arguing that the bondholders' claims should be disallowed as duplicative of the Fiscal Agent's claim. In addition, the Creditors'

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Committee filed an objection to System bondholder claims, reiterating that it seeks disallowance of the bondholders' claims on ultra vires grounds and, alternatively, the System bondholders' asserted secured claims against the System's property are limited only to employer contributions held by the System on its Title III case petition date that are identifiable from other System assets, which System bondholders will not be able to show.

System Clawback Litigation, Adv. Pro. Nos. 19-355, 19-356, 19-357, 19-358, 19-359, 19-360, and 19-361-LTS (D.P.R. May 19, 2019)

On May 19, 2019, the Creditors' Committee and the Oversight Board, acting through its Special Claims Committee, commenced seven adversary proceedings (collectively, the System Clawback Litigation) against approximately 230 defendants that owned or currently own Bonds. The plaintiffs seek declaratory relief relating to the Bonds and recovery of certain payments of principal and interest on the Bonds. On May 21, 2019, the plaintiffs filed a motion requesting that the Title III Court enter an order (i) extending the period for serving domestic defendants in the Avoidance Actions to November 18, 2019, and (ii) otherwise staying the Avoidance Actions pending a joint request by both plaintiffs to resume a particular proceeding or further order of the Title III Court.

On July 24, 2019, the Title III Court entered an order staying the System Clawback Litigation through November 30, 2019 and required mandatory mediation of the issues during the stay period.

On October 18, 2019, the parties to the System Clawback Litigation jointly filed a motion and stipulated order seeking to modify the July 24, 2019 stay order Stay Order by allowing for the ultra vires issues related to the ERS Bonds System bonds to proceed. The On October 24, 2019, the Title III Court has not yet entered the stipulated order.granted the motion to modify the July 24 Stay Order and established a discovery and briefing schedule related to the ultra vires issues through May 2020. On November 1, 2019, defendant bond holders commenced discovery against various parties and non-parties, including the System, related to the ultra vires issues. As of the date hereof, the discovery process is ongoing.

On October 28, 2019, the Title III Court entered an order requiring a mediation report and/or scheduling order as to the remaining stayed matters by November 27, 2019 and extended the stay on non-ultra vires matters through December 31, 2019. On December 27, 2019, the Title III Court entered an amended order extending the stay on non-ultra vires matters through March 11, 2020. On March 10, 2020, the Title III Court entered a final order on the stay period, authorizing certain lift stay motions and revenue bond complaints to proceed but otherwise kept the stay in place for proceedings that do not involve ultra vires and/or lien-scope issues pending the Title III Court's decision on confirmation of the Amended Plan (defined below).

Lien-Scope Adversary Proceedings, Adv. Pro. Nos. 19-00366-LTS (D.P.R.) and 19-00367-LTS (D.P.R.).

On May 20, 2019, the System and the Creditors' Committee commenced separate adversary proceedings (collectively, the "Lien-Scope Actions") against the Fiscal Agent and certain beneficial

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owners of the Bonds, alleging that the defendants do not hold valid and enforceable security interests in any of the System's remaining assets or the proceeds thereof (except certain accounts receivable).

On July 24, 2019, the Title III Court entered an order staying Lien-Scope Actions through November 30, 2019 and required mandatory mediation of the issues during the stay period.

On October 18, 2019, the parties to the Lien-Scope Actions jointly filed a motion and stipulated order seeking to modify the July 24, 2019 stay order Stay Order by allowing for issues regarding the scope of the System bondholders' liens the lien-scope issues raised in the complaints to proceed.

On October 24, 2019, the Title III Court has not yet entered the stipulated order.granted the motion and established a discovery and briefing schedule related to the lien-scope issues through May 2020. On November 1, 2019, defendant bondholders commenced discovery against various parties and non-parties, including the System. As of the date hereof, the discovery process is ongoing.

On October 28, 2019, the Title III Court entered an order requiring a mediation report and/or scheduling order as to the remaining stayed matters by November 27, 2019 and extended the stay through December 31, 2019 as to all other matters not related to the lien-scope issues. On November 27, 2019, the court-appointed mediation team filed an interim status report, which provided recommended scheduling and sequencing of certain key litigation issues, including (i) the validity of certain challenged series of GO and PBA bonds; (ii) the secured or unsecured status of claims on GO and PBA bonds; and (iii) the rights, as against the Commonwealth, of holders of revenue bonds and other debt issued by certain Puerto Rico instrumentalities. Under the proposed scheduling order contained in the interim status report, the mediation team has proposed initial briefing on these issues to commence in February 2020 with hearings scheduled on April 30, 2020 and in June 2020. On December 27, 2019, the Title III Court entered an amended order extending the stay through March 11, 2020. On February 10, 2020, the mediation team filed an amended report and recommendation and parties filed their responses to the amended report on February 21, 2020. On March 10, 2020, the Title III Court entered a final order on the stay period, authorizing certain lift stay motions and revenue bond complaints to proceed but otherwise kept the stay in place for proceedings that do not involve ultra vires and/or lien-scope issues pending the Title III Court's decision on confirmation of the Amended Plan (refer to note 14 for details).

The Fin. Oversight & Mgmt. Bd. for Puerto Rico v. Vásquez, Adv. Pro. No. 19-00393 (D.P.R.) (Jul. 3, 2019)

On July 3, 2019, the Oversight Board filed a complaint against the Governor and FAFAA seeking injunctive relief to prevent the implementation and enforcement of Act 29-2019, which eliminated the obligation of municipalities to make PayGo payments to the Commonwealth, and various joint resolutions because (i) Act 29 violated PROMESA sections 204(a) and 207; (ii) Act 29-2019 and the joint resolutions violated PROMESA section 204(c); (iii) Act 29-2019 and the joint resolutions violated PROMESA section 108(a) because they impair and/or defeat the purposes of PROMESA, as determined by the Oversight Board; and (iv) the Governor's alleged policy of not providing certifications as required under PROMESA section 204 violated PROMESA section 108(a) because it impairs and/or defeats the purposes of PROMESA, as determined by the Oversight Board.

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On July 15, 2019, the Governor and FAFAA moved to dismiss the complaint. On August 22, 2019, the Title III Court denied the motion to dismiss in its entirety. On September 10, 2019, the Governor and FAFAA answered the complaint. On December 13, 2019, the Oversight Board filed a motion for summary judgment. On February 5, 2020, the Governor and FAFAA filed their opposition to the Oversight Board's summary judgment motion. On March 5, 2020, the Title III Court heard oral argument on the summary judgment motion. As of the date hereof, the Title III Court has not yet made a final determination on the merits or issued its decision.

ERS Bondholders' Motion to Appoint Trustee, Case No. 17-03566-LTS (D.P.R. Nov. 19, 2019)

On November 19, 2019, a certain a group of System Bondholders (including Andalusian Global, Crown Managed Accounts, Glendon Opportunities, LMA SPC, Mason Capital, Oaktree, Oceana, and Pentwater) filed a motion (the Trustee Motion) in the System's Title III case arguing that the Court should appoint a trustee pursuant to Bankruptcy Code section 926 to pursue avoidance claims against the Commonwealth on behalf of the System. Movants specifically sought to have a trustee appointed to avoid alleged transfers made by the System to the Commonwealth pursuant to pension reform legislation enacted by the Commonwealth government. Movants asserted that the Oversight Board unjustifiably refused to pursue these avoidance claims and that the Oversight Board had a conflict of interest because it represents both the Commonwealth and the System. On January 7, 2020, the Title III Court denied the Trustee Motion, and on January 10, 2020, the System Bondholders filed an appeal to the United States Court of Appeals for the First Circuit. On March 19, 2020, the First Circuit issued an opinion affirming the Title III Court's order denying the Trustee Motion

In addition to the foregoing matters, the System is a defendant or co-defendant in various lawsuits resulting from the ordinary conduct of its operations. Based on the advice of legal counsel and considering insurance coverages, management is of the opinion that the ultimate liability, if any, will not have a material effect on the financial status of the System.

(14) Subsequent Events

Subsequent events were evaluated through June 29, 2020, the date the financial statements were available to be issued, to determine if such events should be recognized or disclosed in the 2017 financial statements. The subsequent events disclosed below are principally those related to debt activities, including fiscal events and related legislation, both local and federal, that management believes are of public interest for disclosure.

A. Sale of System Investments

On June 23, 2017, the Legislative Assembly approved certain other assignments for fiscal year 2018 under Joint Resolution 188, which among other things, ordered the System, JRS, and TRS to liquidate their assets and pass the net proceeds to the Treasury Department. In July 20, 2017, the System sold investments in the total aggregate amount of approximately \$297 million and transferred approximately \$190 million of the net proceeds to the Treasury Department as required under Joint Resolution 188.

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B. PayGo Pension Reform

On June 27, 2017, the Treasury Department issued Circular Letter No. 1300-46-17 to convey to the central government agencies, public corporations and municipalities the new implementation procedures to adopt, effective July 1, 2017, a new "pay-as-you-go" (PayGo) system. With the start of fiscal year 2018, employers' contributions, contributions ordered by special laws, and the Additional Uniform Contribution were all eliminated.

The PayGo system was one component of Act 106-2017, which the Governor signed into law on August 23, 2017. Act 106-2017 created the legal framework for the Commonwealth to guarantee benefit payments to pensioners through the PayGo system. Approximately \$2 billion was allocated for these purposes in each of the budgets for fiscal year 2018 and fiscal year 2019. Act 106-2017 also created a Defined Contributions Plan, similar to a 401(k) plan, that will be managed by a private entity. Future benefits will not be paid by the Retirement Systems.

Act 106-2017, among other things, amended Act No. 12 with respect to the System's governance, funding and benefits for active members of the actual program and new hired members. Under Act 106-2017, the System's board of trustees was eliminated and a new Retirement Board was created. The Retirement Board is currently responsible for governing both the System, JRS and TRS.

Act 106-2017 terminated the previously existing pension programs for the System participants as of June 30, 2017. The members of the prior programs and new system members hired on and after July 1, 2017 will be enrolled in a new defined contributions program that will be selected by the Retirement Board. The accumulated balance on the accounts of the prior program will be transferred to the member accounts in the new defined contribution program. The System's active members of the defined contributions program will retain their benefits as stated under Act 91 of March 29, 2003.

Act 106-2017 also ordered a suspension of the System's loan programs and ordered a merger of the administrative structures of the retirement systems. At the Retirement Board's discretion, the administration of the System benefits may be externalized. The employees of the System that are not retained under the new administrative structure will be transferred to other public agencies in conformity with Act No. 8 of February 8, 2017.

In addition, Act 106-2017 repealed the Voluntary Early Retirement Law, Act No. 211 of 2015, while creating an incentives, opportunities and retraining program for public workers.

On May 17, 2019, the Legislature passed Act No. 29 of 2019 (Act 29-2019), which addressed the severe financial crisis and liquidity shortage of the Puerto Rico municipalities by relieving them of their obligation to make PayGo payments to the Commonwealth under Act 106-2017. The Oversight Board has challenged the implementation and enforcement of Act 29-2019, as discussed in note 13 to the basic financial statements.

On January 30, 2020, the United States Court of Appeals for the First Circuit entered an opinion in the System Declaratory Relief Action upholding the Title III Court's determination that Bankruptcy Code section 552 prevents System bondholders' security interests from attaching to post-petition revenues

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and finding that employers' contributions are not "special revenues" within the meaning of Bankruptcy Code section 902. As a result, the First Circuit has determined that System bondholders do not have a security interest in employer contributions received after the System's petition date.

For additional information regarding litigation related to Act 106-2017 and the PayGo system, refer to note 13 to the basic financial statements.

C. Debt Investigation Report

On August 2, 2017, the Oversight Board announced its intention, under its authority under PROMESA, to conduct an investigation to review the financial crisis and its contributors, and examine Puerto Rico's debt and its issuance, including disclosure and selling practices. To that end, the Oversight Board named a special investigation committee (the Special Investigation Committee), and conducted a competitive process to identify and select an independent firm to conduct the investigation. On September 13, 2017, the Oversight Board announced that the Special Investigation Committee retained an independent investigator to carry out a review of the Commonwealth's debt and its connection to the current financial crisis. The Oversight Board published the independent investigator's final report on August 20, 2018 (the Debt Investigation Report). The Debt Investigation Report provides an analysis of the historical and more recent macroeconomic and political factors contributing directly and indirectly to the Commonwealth's fiscal and economic crisis, the Commonwealth's municipal bond issuance process, and legislative efforts to restructure the debt, as well as the Oversight Board's investigative findings, policy recommendations, and identification of potential claims and matters for regulatory attention.

The Debt Investigation Report presented findings and recommendations on the following areas:

- GDB
- Puerto Rico Public Utilities (PREPA and PRASA)
- COFINA
- The System
- Puerto Rico's Budgeting, External Reporting, and Accounting Functions
- Calculation of the Constitutional Debt Limit
- Credit Rating Agencies (CRAs)
- Selling Practices for Puerto Rico-Related Bonds
- Puerto Rico's Government Ethics Framework
- Issuers' Use of Interest Rate Swaps
- Puerto Rico's Lack of a Clear Mechanisms for Validating Puerto Rico-Related Bonds Before They Issue
- Possession Tax Credit

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The independent investigator also presented an overview of potential causes of action. The Debt Investigation Report in its entirety can be found on the Oversight Board's website.

On August 28, 2018, the Oversight Board appointed a special claims committee (the Special Claims Committee) and delegated to the Special Claims Committee any and all authority of the Oversight Board to review the findings in the Debt Investigation Report and to take any appropriate steps, including without limitation, recommending and/or initiating the negotiation and/or prosecution of claims based on the findings in the Debt Investigation Report on behalf of the Title III debtors for the benefit of all creditors and parties in interest in the Title III cases. The Special Claims Committee is entitled, in its full discretion, to determine the scope of any further action, including, but not limited to, additional investigation, as well as claims to be pursued, and to retain such advisors, consultants, attorneys or other advisors as it in its sole discretion sees fit. On October 25, 2018, the Special Claims Committee signed the contract with the firm that will provide those services. The System is cooperating with this investigation.

For more information on the adversary proceedings and other motions in the Title III cases commenced by the Special Claims Committee against the System, refer to note 13 to the basic financial statements.

D. Impact of Natural Disasters

On September 6, 2017 and September 20, 2017, Hurricane Irma and Maria respectively made landfall in Puerto Rico. The hurricanes causes unprecedented and catastrophic damage to the island, its people and its business. As result of Hurricane Maria, the System's headquarters suffered major damages. To continue operations, the System had to relocate its offices and entered into a lease agreement with the Puerto Rico Public Buildings Authority. As a result of the relocation, the System eliminated certain of its prior contracts related to auxiliary services and negotiated new ones.

On December 28, 2019, the first of many earthquakes shook Puerto Rico. Since then, there have been more than 400 earthquakes of magnitude 2 or greater on the Richter scale, including its most destructive earthquake in a century with a magnitude of 6.4. Based on preliminary estimates, these earthquakes have caused approximately \$500 million in damages, and thousands of Puerto Rico residents have been forced into refugee camps, as they are afraid to sleep in homes that could collapse in an aftershock. According to a January 29, 2020 report published by the United States Geological Survey, the aftershocks in Puerto Rico are not expected to stop any time soon, with earthquakes of at least a magnitude of 3 or greater expected to occur daily over the next several months and thereafter weekly for years.

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E. Former Governor Rosselló's Resignation and Government Transition under Governor Vázquez

On July 24, 2019, then-Governor Ricardo Rosselló Nevares announced his resignation as Governor of the Commonwealth effective August 2, 2019 at 5pm Atlantic Standard Time. Before his resignation became effective, then-Governor Rosselló appointed former resident commissioner Pedro Pierluisi as Secretary of State. After being confirmed by the House of Representatives (but not the Senate), Mr. Pierluisi was sworn in as acting Governor. On August 7, 2019, the Puerto Rico Supreme Court unanimously determined that Mr. Pierluisi was illegally sworn into office as Governor. As a result, Justice Secretary Wanda Vázquez was sworn in as Governor on August 7, 2019 to complete former Governor Rosselló's term through 2020 and, as of the date of these financial statements, currently serves as the Governor of the Commonwealth.

F. Oversight Board Files Joint Plan of Adjustment for the Commonwealth, the System, and PBA

On September 27, 2019, the Oversight Board – as representative of the Commonwealth, the System, and PBA in their respective Title III cases – filed its initial joint Title III plan of adjustment for the Commonwealth, the System and PBA [ECF No. 8765] (the Initial Plan) along with a disclosure statement related thereto [ECF No. 8765] (the Initial Disclosure Statement). On February 28, 2020, the Oversight Board filed its *Amended Title III Joint Plan of Adjustment of the Commonwealth of Puerto Rico, et al.* [ECF No. 11946] (the Amended Plan) and an amended disclosure statement related thereto [ECF No. 11947] (the Amended Disclosure Statement), which revised the Initial Plan to conform to the PSA.

The Amended Plan and Amended Disclosure Statement do not reflect the potential impact from the on-going outbreak of a respiratory illness caused by a novel (new) coronavirus known as COVID-19 first identified in Wuhan, Hubei Province, China. As a result, on March 23, 2020, the Oversight Board filed an urgent motion requesting to adjourn consideration of the Amended Disclosure Statement – currently scheduled for June 3 and June 4, 2020 – until further notice.

The Amended Plan and Amended Disclosure Statement remain subject to future amendments, particularly given the potential economic impact of COVID-19, and Title III Court approval, and it is not certain that the Title III Court will ultimately confirm the Amended Plan.

For further information, please refer to the publicly available Amended Plan and Amended Disclosure Statement, available at <https://cases.primeclerk.com/puertorico/Home-DocketInfo>.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
(A Component Unit of the Commonwealth of Puerto Rico)

Notes to Basic Financial Statements

June 30, 2017

G. Cybersecurity Attack

During January 2020, the System discovered that an external agent gained access to the System's Office 365 application. Apparently, the attacker impersonated a Finance Department's employee email account and sent electronic communications to multiple public corporations. In the aforementioned electronic communications, the attacker gave instructions to change deposit bank accounts. This event did not involve an intrusion in the System's accounting system, nor bank accounts, and System's participants personal information. This event is under state and federal investigation. As of the date of this financial statements four public corporations transferred funds to the fraudulent banks accounts of approximately \$4.4 million. The System is still investigating the matter and contracted the services of GM Security Technologies to investigate in deep this incident and provide recommendations to the System's IT security policies. The System is also evaluating the effects of this cyber-attack and could include loss of revenues, increases in cybersecurity costs and an increase in insurance premiums, among others.

H. Coronavirus Pandemic

On March 15, 2020, the Governor of Puerto Rico issued the Executive Order #OE-2020-023 to make the necessary closures of the government and private companies to combat the effects of Coronavirus (COVID-19). The closure consists of a 14-days lock down and social distancing from March 16 to March 30, 2020. After this date, various executive orders were issued extending the closures of the government and private companies. The most recent was the Executive Order #OE-2020-048 issued on June 28, 2020 eliminates the lock down previously imposed and reduces the curfew hours imposed on the citizens of Puerto Rico and the control measures implemented to contain the spread of the COVID-19 through the island until July 22, 2020.

As the result of the Executive Order, the System closed its operations effective March 16, 2020 and our operations since such date are very limited. The effect of the closing on our operations cannot be reasonable estimated at this time but we believe this closing will have a limited impact in our financial statements and operations.

REQUIRED SUPPLEMENTARY INFORMATION

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
(A Component Unit of the Commonwealth of Puerto Rico)

Schedule of Changes in the Employers' Net Pension Liability and Related Ratios –
Pension Benefits (Unaudited)

Years ended June 30, 2017 and 2016

(Dollars in thousands)

| | 2017 | 2016 |
|--|----------------------|--------------------|
| | Amount | Amount |
| Total pension liability: | | |
| Service cost | \$ 628,025 | 496,732 |
| Interest | 1,035,844 | 1,230,843 |
| Differences between expected and annual experience | (248,414) | (252,405) |
| Changes in assumptions | (4,179,110) | 3,853,693 |
| Plan changes | (2,017,468) | — |
| Benefit payments, including refunds of contributions | <u>(1,559,924)</u> | <u>(1,565,152)</u> |
| Net change in total pension liability | (6,341,047) | 3,763,711 |
| Total pension liability – beginning | <u>36,432,873</u> | <u>32,669,162</u> |
| Total pension liability – ending (a) | <u>30,091,826</u> | <u>36,432,873</u> |
| Plan's fiduciary net position (deficit): | | |
| Employer contributions – net of provision | 921,537 | 779,477 |
| Member contributions | 320,095 | 333,633 |
| Net investment income | 28,155 | 870 |
| Other income | 56,626 | 110,201 |
| Benefit payments, including refunds of member contributions | (1,559,924) | (1,565,152) |
| Administrative expenses | (24,358) | (27,670) |
| Interest on bonds payable | (198,084) | (196,211) |
| Other expenses | <u>(387,015)</u> | <u>(32,761)</u> |
| Net change in plan fiduciary net position | (842,968) | (597,613) |
| Total fiduciary net position (deficit) – beginning | <u>(1,265,885)</u> | <u>(668,272)</u> |
| Total fiduciary net position (deficit)– ending (b) | <u>(2,108,853)</u> | <u>(1,265,885)</u> |
| Employers' net pension liability – ending (a)-(b) | <u>\$ 32,200,679</u> | <u>37,698,758</u> |
| Plan's fiduciary net position (deficit) as a percentage of the total pension liability | (7.01)% | (3.47)% |
| Covered employee payroll | \$ 3,344,197 | 3,344,382 |
| Employers' net pension liability as a percentage of covered employee payroll | 962.88 % | 1127.23% |

Note: Schedule is intended to show information for ten years. Additional years will be displayed as they become available.

See accompanying notes to required supplementary information and independent auditors' report.

**EMPLOYEES’ RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
(A Component Unit of the Commonwealth of Puerto Rico)
Schedule of Investment Returns – Pension Benefits (Unaudited)

| Fiscal year ended (1) | Annual money-weighted rate of return, net of expenses |
|------------------------------|--|
| June 30, 2017 | 6.8 % |
| June 30, 2016 | 6.7 |
| June 30, 2015 | 4.2 |

(1) Schedule is intended to show information for ten years. Additional years will be displayed as they become available.

See accompanying notes to required supplementary information and independent auditors’ report.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
(A Component Unit of the Commonwealth of Puerto Rico)
Schedule of Employers' Contributions – OPEB (Unaudited)
(Dollars in thousands)

| Fiscal year ended (1) | Annual required contributions | Actual employers' contributions | Percentage of contribution |
|------------------------------|--|--|---------------------------------------|
| June 30, 2017 | \$ 105,859 | 91,280 | 86.2 % |
| June 30, 2016 | 107,739 | 93,728 | 87.0 |
| June 30, 2015 | 103,878 | 97,374 | 93.7 |
| June 30, 2014 | 88,508 | 102,085 | 115.3 |
| June 30, 2013 | 154,999 | 91,823 | 59.2 |
| June 30, 2012 | 133,654 | 94,664 | 70.8 |
| June 30, 2011 | 129,395 | 93,851 | 72.5 |
| June 30, 2010 | 128,294 | 88,599 | 69.1 |

(1) The System's annual required contributions for the year ended June 30, 2017 and 2016 were determined by the actuarial valuation at beginning of year that was updated to roll forward the funded status to June 30, 2017 and 2016 and assuming no liability gains or losses. Prior year actuarial valuations were made using end-of-year census data.

See accompanying notes to required supplementary information and independent auditors' report.

EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO
(A Component Unit of the Commonwealth of Puerto Rico)
Schedule of Funding Progress – OPEB (Unaudited)
(Dollars in thousands)

| Actuarial valuation date (1) | Actuarial value of plan assets | Actuarial accrued liability (AAL) | Unfunded Actuarial accrued liability (UAAL) | Funded ratio | Annual covered payroll | UAAL percentage of annual covered payroll |
|------------------------------|--------------------------------|-----------------------------------|---|--------------|------------------------|---|
| June 30, 2017 | \$ — | 1,138,309 | 1,138,309 | — % | \$ 3,344,197 | 34.0 % |
| June 30, 2016 | — | 1,349,503 | 1,349,503 | — | 3,344,382 | 40.4 |
| June 30, 2015 | — | 1,428,788 | 1,428,788 | — | 3,319,280 | 43.0 |
| June 30, 2014 | — | 1,438,475 | 1,438,475 | — | 3,489,096 | 41.2 |
| June 30, 2013 | — | 1,482,879 | 1,482,879 | — | 3,489,096 | 42.5 |
| June 30, 2012 | — | 2,120,970 | 2,120,970 | — | 3,570,339 | 59.4 |
| June 30, 2011 | — | 1,758,389 | 1,758,389 | — | 3,666,402 | 48.0 |
| June 30, 2010 | — | 1,699,373 | 1,699,373 | — | 3,818,332 | 44.5 |

(1) The System's OPEB funded status as of June 30, 2017 and 2016 were determined by the actuarial valuation at beginning of year that was updated to roll forward the funded status to June 30, 2017 and 2016 and assuming no liability gains or losses. Prior year actuarial valuations were made using end-of-year census data.

See accompanying notes to required supplementary information and independent auditors' report.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Notes to Required Supplementary Information

June 30, 2017

(1) Changes in Benefits Terms

There have not been any changes in plan provisions since the prior valuation.

(2) Changes in Assumptions

Actuarial assumptions are revised periodically to more closely reflect actual, as well as anticipated future experience.

Based on the depletion of System assets during recent fiscal years and the implementation PayGo under Act 106-2017, the investment return assumption is no longer applicable to the System as of June 30, 2017. As of June 30, 2016, the investment return assumption was 6.55% per annum, net of investment expenses and based on the System's investment policy, including target asset allocation and expectations regarding the loan portfolio and the System's actuary's capital market assumptions as of June 30, 2016.

The projected mortality improvement scale was updated from Scale MP-2016 to Scale MP-2017, which was published by the Society of Actuaries in October 2017. Also, as Scale MP-2015 is a two-dimensional mortality scale, the base mortality rates for the post-retirement mortality assumption were set to the 2010 rates – the central year of the 2007 to 2012 System experience study upon which the rates were based. In addition, the pre-retirement mortality rates were also updated to reflect updated mortality tables published by the Society of Actuaries.

The asset basis for the date of depletion projection is the System's fiduciary net position (the gross assets plus deferred outflows of resources less the gross liabilities, including the senior pension funding bonds payable, plus deferred inflows of resources). On this basis, the System's fiduciary net position was exhausted in the fiscal year 2015.

In addition, the date of depletion projection of the actuarial report does not include any amounts from the Additional Uniform Contribution required by Act No. 32 because of actual fiscal and budgetary financial difficulties with continued budget deficits and liquidity risks of the Commonwealth, public corporations and the municipalities and in the event that their financial condition does not improve in the near term. In addition, Act 106-2017 eliminated the Additional Uniform Contribution.

The System's fiduciary net position was not projected to be available to make all projected future benefit payments of current active and inactive employees. Therefore, the tax free municipal bond index (Bond Buyer General Obligation 20-Bond Municipal Bond Index) was applied to all periods of projected benefits payments to determine the total pension liability.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
OF THE COMMONWEALTH OF PUERTO RICO**
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Notes to Required Supplementary Information
June 30, 2017

The discount rate used to determine the total pension liability increased from 2.85% at June 30, 2016 to 3.58% at June 30, 2017, determined under GASB Statement No. 67. Under GASB Statement No. 67, the investment return assumption is an input that is used in the calculation of the single equivalent interest rate that is used to discount these benefits to determine the Total Pension Liability. Under former GASB Statements No. 25 and No. 27, the investment return assumption was used to discount all projected Basic System Pension Benefits and System Administered Pension Benefits to determine the Actuarial Accrued Liability. For fiscal years 2008 to 2010 and for fiscal years 2011, 2012 and 2013, the discount rates determined under GASB Statements No. 25 and No. 27 were 7.50%, 6.40%, 6.00% and 6.40%, respectively.

Also, the valuations for fiscal year 2017 and 2016 reflect a salary freeze until July 1, 2017 due to Act No. 66 and the current economic conditions in Puerto Rico.

(3) Changes in Actuarial Methods since the prior Valuation

There have not been any changes in methods since the prior valuation.

In fiscal years 2017 and 2016, the census data collection date is as of beginning-of-fiscal-year. The total pension liability at end of year was determined by actuarial valuation as of the census data collection date at beginning-of-year and was then projected forward to end-of-year, using roll-forward methods and assuming no liability gains or losses.

The June 30, 2017, actuarial valuation reflects a decrease of \$5,498 million in the net pension liability, mainly related to changes in assumptions of \$4,179 million, as a result of an increase in the discount rate as required by GASB Statement No. 67 from 2.85% in fiscal year 2016 to 3.58% in fiscal year 2017, and the effect of plan changes of approximately \$2,017 million.

(4) Method and Assumptions Used in the System's Actuarial Valuation

The following actuarial methods and assumptions were used in the System's actuarial valuation of June 30, 2017:

| | |
|----------------------------|--|
| Actuarial cost method | Entry age normal |
| Asset valuation method | Market value of assets |
| Inflation | Not applicable |
| Municipal bond index | 3.58%, as per Bond Buyer General Obligation 20-Bond Municipal Bond Index |
| Projected salary increases | 3.00% per year. No compensation increases are assumed until July 1, 2021 as a result of Act No. 3 of 2017, four year extension of the Act 66-2014 and the current general economy. |

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT
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Notes to Required Supplementary Information

June 30, 2017

Mortality

Pre-retirement Mortality:

For general employees not covered under Act No. 127, RP-2014 Employee Mortality Rates for males and females adjusted to reflect Mortality Improvement Scale MP-2017 from the 2006 base year, and projected forward using MP-2017 on generational basis. For members covered under Act No. 127, RP-2014 Employee Mortality Rates with blue collar adjustments for males and females adjusted to reflect Mortality Improvement Scale MP-2017 from the 2006 base year, and projected forward using MP-2017 on generational basis. As generational tables, they reflect mortality improvements both before and after the measurement date. 100% of deaths while in active service are assumed to be occupational for members covered under Act No. 127.

Post-retirement Healthy Mortality:

Rates which vary by gender are assumed for healthy retirees and beneficiaries based on a study of plan's experience from 2007 to 2012 and updated expectations regarding future mortality improvement. The 2010 base rates are equal to 92% of the rates from the UP-1994 Mortality Table for Males and 95% of the rates from the UP-1994 Mortality Table for Females, both projected from 1994 to 2010 using Scale AA. The base rates are projected using Mortality Improvement Scale MP-2017 on a generational basis. As a generational table, it reflects mortality improvements both before and after the measurement date.

Post-retirement Disabled Mortality:

Rates which vary by gender are assumed for disabled retirees based on a study of plan's experience from 2007 to 2012 and updated expectations regarding future mortality improvement. The 2010 base rates are equal to 105% of the rates from the UP-1994 Mortality Table for Males and 115% of the rates from the UP-1994 Mortality Table for Females. The base rates are projected using Mortality Improvement Scale MP-2017 on a generational basis. As a generational table, it reflects mortality improvements both before and after the measurement date.